SBA GUARANTEED LOAN POLICIES

HEARING
BEFORE THE
SUBCOMMITTEE ON GENERAL OVERSIGHT
OF THE
COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES
NINETY-SEVENTH CONGRESS
FIRST SESSION

WASHINGTON, D.C., JULY 30, 1981

Printed for the use of the Committee on Small Business

87-807 O
U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1981

H721-15

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CONTENTS

Page

Hearing held on July 30, 1981 1

Opening statements of:
  Addabbo, Hon. Joseph P., a Representative in Congress from the State of New York 3
  Dreier, Hon. David, a Representative in Congress from the State of California 3
  LaFalce, Hon. John J., chairman, Subcommittee on General Oversight 1
  Roemer, Hon. Buddy, a Representative in Congress from the State of Louisiana 3

Testimony of:
  Bolt, William, vice chairman, United Missouri Bank, Kansas City, Mo 18
  Cardenas, Michael, Administrator, Small Business Administration, accompanied by Edwin T. Holloway, Acting Associate Administrator for Financial Assistance 87
  Kleiner, Jack, attorney at law, Kleiner & Merren, Atlanta, Ga., and business professor, Georgia Tech 22
  Piercy, Ronald, president, A-D-E Lumber & Supply Co., Inc., Kansas City, Mo 4
  Ruch, Paul E., executive vice president, Marine Midland Bank, Buffalo, N.Y 29

Additional material supplied for the hearing record:
  Bolt, William, vice chairman, United Missouri Bank, Kansas City, Mo.: Attachments to testimony 20
  Cardenas, Michael, Administrator, Small Business Administration: Prepared statement and attachments 90
  Kleiner, Jack, attorney at law, Kleiner & Merren, Atlanta, Ga., and business professor, Georgia Tech:
    Brief in the *Banco De Venezuela* case 47
    Complaint in *Downs* v. *United Kentucky Bank* 55
    Memorandum in *Kleiner* v. *First National Bank of Atlanta* 41
    Prepared statement 25
    Study entitled "Short-Term Business Lending at Rates Below the Prime Rate" 61
  Piercy, Ronald, president, A-D-E Lumber & Supply Co., Inc., Kansas City, Mo.:
    Charts on A-D-E's 10-year analysis of operating expenses 10
    Magazine article from August 1981 issue of Inc 17
  Ruch, Paul E., executive vice president, Marine Midland Bank, Buffalo, N.Y.: Prepared statement 30

SBA GUARANTEED LOAN POLICIES

THURSDAY, JULY 30, 1981

House of Representatives,
Subcommittee on General Oversight,
Committee on Small Business,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:10 a.m. in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LaFALCE

Mr. LaFalce. The General Oversight Subcommittee will come to order.

The subcommittee is holding hearings today on how the Small Business Administration sets the maximum interest rate that lenders are allowed to charge on SBA guaranteed business loans.

This is an issue that has been of great concern to the small business community as interest rates have skyrocketed. Small businessmen have complained that the prime rate is not the rate that it is popularly thought to be—the best interest rate charged by a bank to its best customer. Instead, they contend, it is a phony rate somewhere in between what the bank's best customer pays on its loan and what they are charged for theirs.

The House Banking Committee, on which I also serve, focused public attention last spring on how SBA's interest rate policies have perpetuated this problem. In a staff study issued on April 30, our Banking Committee exposed the abuse and misuse of the prime by major U.S. banks. The committee criticized SBA's use of the money center prime rate published daily in the Wall Street Journal as the benchmark for setting the interest rate ceiling on its guaranteed loans.

In my capacity as chairman of this subcommittee, I followed up on that report. I told SBA at least 3 weeks ago that I planned to hold hearings on the prime rate issue. I said that I wanted to focus on three interrelated issues:

First, how the SBA was accentuating high interest rates by tying the interest ceiling on its guaranteed business loans to the prime plus a premium. Since July 1980, SBA has permitted lenders to charge up to 2¾ percent above prime. Even though it does not mandate that lenders charge that rate, the fact that SBA set that figure as the ceiling could easily lead banks to charge the maximum.

Second, the continued use by SBA of the money center prime as the benchmark after serious questions have been raised about the honesty of the prime.

And third, the effect of SBA plans to lower the percentage of each loan that it would guarantee in its effort to lower interest rates on its guaranteed business loans.

I was gratified when I learned last Friday that SBA would be announcing plans this week to lower the interest rate ceiling on its guaranteed business loans from the prime plus premium to simply the money center prime rate published in the Wall Street Journal. It would, however, allow a lender to use its prime rate as the ceiling if it is published daily in a general circulation newspaper. In addition, I was glad to see that SBA recognized in its press release the controversy over the honesty of the prime rate and asked for public comment on other interest rates that could be used to set the maximum rate on guaranteed loans.

SBA's announcement of its policy changes regarding the prime rate provides an excellent opportunity for our subcommittee to look ahead and initiate a constructive discussion of what new benchmark could be used to set the interest rate ceiling for its guaranteed loans.

I wholeheartedly agree with Administrator Cardenas that a new measure must be found. I think there is widespread agreement that a new peg rate should be selected that represents a market measure—not a price-fixed measure—of changes in lending costs. Possible replacements include the commercial paper rate, the rate on certificates of deposit, the rate on bankers' acceptances, and the Treasury bill rate. It is essential that the new measure be equitable for both the lender and the borrower.

I noted, however, in reading the Agency's request for suggestions that the comment period was open-ended. Therefore, to facilitate a timely selection of a new prime rate, I would appreciate a report from the Administrator by October 30, 1981, summarizing and evaluating the comments received by SBA and informing the subcommittee of SBA's plans as of that time to adopt a new peg rate.

We will be hearing this morning from bankers, a small businessman and a lawyer who has launched several legal challenges against the bank use of the prime rate. I hope their testimony will help SBA develop the new benchmark that is needed for its guaranteed loan program.

There is one issue that I fear may undercut SBA's excellent intentions in regard to interest rates, though. That matter involves the Agency's consideration of reductions in the guarantee levels on its guaranteed business loans. The purpose of a guarantee is to offset risk. Many small business loans are considered to carry a significant element of risk, and the Government guarantee is intended to remove that risk and encourage banks to make these loans at reasonable and affordable interest rates.

At SBA's request, the House-Senate SBA Budget Conference adopted changes in the guarantee percentages on SBA business loans that may make it difficult for lenders to lend at the lower interest rates that you and I believe are required. We will hear testimony on this issue from a leading banker whose institution has been very active in SBA lending programs.

It is essential that this problem be resolved. The health and vigor of the small business sector is dependent upon its ability to get loans at interest rates it can pay. All would agree that a more equitable peg rate for the ceiling on SBA-guaranteed business loans is needed and that guarantee levels have to be adequate to attract bank participation in SBA's guaranteed loan program. Nothing should stand in the way of achieving these goals.

Before we call the witnesses to the table, I wonder if any members of the subcommittee have any brief statements they would like to make?

OPENING STATEMENT OF HON. JOSEPH P. ADDABBO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Addabbo. Mr. Chairman, if you will yield, I thank the chairman for yielding. I have to apologize. As usual, we have defense hearings which I must chair, but I believe this hearing is very important, especially in view of the fact that in the reconciliation, direct loans have been reduced and they are almost down to nil. As a result, the only remaining avenue left for small business is the guaranteed loan program and the interest rate becomes a very important factor.

Also, I was happy to receive the SBA news report of its statement of reduced interest and I would ask that it be made part of the record. I hope that interest rates and the program is constantly reviewed, and I look forward to the report requested by you. The program is important in light of high interest rates, and the fact that Congress passed yesterday tremendous tax allowance increases as a result of which the great loss of revenue which will probably in turn trigger higher inflation and possibly even higher interest rates. We must protect small business and they must survive.

Mr. LaFalce. Do any other members of the panel have comments they would like to make?

Mr. Roemer. Yes.

Mr. LaFalce. Mr. Roemer.

OPENING STATEMENT OF HON. BUDDY ROEMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. Roemer. Thank you, Mr. Chairman.

I want to compliment the chairman of our subcommittee for holding these hearings and lend my support in the search for some equity in this business of interest charged on these loans. I particularly commend the chairman for his lead paragraph on page 3 of his statement where he points out quite clearly that we are not looking for a price-fixing measure in terms of interest rates, but an accurate assessment of what the market should bear.

I would like to lend my support to that feeling, Mr. Chairman, and encourage a full discussion of this problem. I compliment you again for the hearings and I look forward to them. Thank you.

OPENING STATEMENT OF HON. DAVID DREIER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Dreier. Thank you, Mr. Chairman. I, too, would like to join in representing the minority to compliment you on holding these hearings. We all know that small business is certainly a tremendously large segment of our economy and it is crucial that we do everything possible to provide stimulus to that side of the economy and hopefully in our search for an equitable interest rate we will be able to solve that problem.

PANEL CONSISTING OF RONALD PIERCY, WILLIAM BOLT, JACK KLEINER, AND PAUL E. RUCH

Mr. **LaFalce**. At this time I would like to call a panel to the table. I would like to ask Mr. Piercy, Mr. Bolt, Mr. Kleiner, and Mr. Paul Ruch if they would all come to the witness table. It is my intention to have all four of you testify and then to have questions from the subcommittee. Subsequent to that, however, I will ask the Administrator of the Small Business Administration to come forward so that we may ask him some questions.

Also, I would like to conclude this no later than 11:15 so that the Administrator can honor his commitments elsewhere. I am however, gratified that he is here at the beginning of the hearing so that he can benefit personally from the testimony which you four gentlemen will present. Mr. Cardenas probably hasn't as yet received any comments of the proposed change in response to the announcement in the Federal Register, but I think the observation you have to make will be especially poignant and I am glad they will be among the first he hears.

First, unless there are objections from other members of the subcommittee, I would like to introduce into the text of the record the prepared statements of Messrs. Piercy, Bolt, Kleiner, Ruch, and Cardenas. Are there any objections?

No objections being heard, they are introduced and the individuals can now proceed to testify as they will, either reading from their testimony or summarizing it. I would ask, however, that each witness attempt to keep his testimony to no more than 10 minutes so that there will be some time for the questions and answers that we would so much like to ask.

Mr. Piercy.

TESTIMONY OF RONALD PIERCY, PRESIDENT, A-D-E LUMBER & SUPPLY CO., INC., KANSAS CITY, MO.

Mr. **Piercy**. Mr. Chairman and members of the subcommittee, my name is Ronald Piercy, and I am president and general manager of a 22-year-old business, the A-D-E Lumber & Supply Co., a family owned and operated wholesale lumber business located in Kansas City, Mo.

I was a delegate to the 1980 White House Conference on Small Business and was chairman of the Kansas City regional delegation to that conference. I currently am one of the 114 representatives of the Small Business National Unity Council, which is a body that that conference formed and charged with the responsibility of implementing the issues that we discussed there.

I am also a member of the Mid-Continent Small Business United group, which is a new coalition of businesses from Missouri, Kansas, Nebraska, and Iowa, and serve on a special MSBU task force of that group on interest rates and monetary policy.

I appreciate the opportunity to testify before the subcommittee today, and I applaud your efforts to investigate the serious problem of high interest rates and their disastrous impact on small businesses that, out of necessity, must rely on borrowed capital for survival. I will also address concerns about Small Business Administration loans and the practice of requiring or allowing a loan to be tied to the New York prime rate with points added.

Our business is both a labor-intensive and a capital-intensive one. As such, the high interest rates smack us with a double whammy. We serve as a source of materials for small, retail lumber businesses and roofing companies and carry a broad base of inventory to meet their needs. Approximately 90 percent of our sales are made to small businesses in rural and urban communities in Missouri and Kansas, and sometimes our willingness or ability to sell to these small firms on a credit basis is the difference between them being able to be in business or not.

Our average gross markup on items is now, and has traditionally been about 10 to 15 percent. Over a period of years, we have averaged about six turns of inventory. For the past 2 years, this turn of inventory has slowed, requiring more capital for us to borrow to finance inventory.

By assuming our normal turns of inventory and normal annual borrowing requirements of about $950,000, plug that into this scenario with a rate of interest of 1½ to 2 percent over the New York based prime rate, and you have a picture of a solid, growing business quickly draining the retained earnings accumulated over two decades of hard work.

We presently have, and have had in the past, SBA-guaranteed loans which were our salvation at the times we received them. Without the SBA loans, we could not have continued to grow and expand, add employees, and increase inventory and service as we did. In pursuing an SBA loan, we had two things in mind: Getting a larger loan for growth and development, and getting a longer term loan. However, I believe, in all candor, one inherent problem with the SBA participating loan is that it is generally tied to the New York prime rate with a factor of 2 to 2¾ percent added above that rate.

Another problem with SBA loans is that they are often adjusted on a twice-a-year basis, sometimes quarterly, instead of more often, such as monthly. In the case of our last loan, the general interest rates rose to a new high in early April or late March 1980, making our rate, paying on our SBA loan, 21½ percent. Our firm then had to survive for the next 6 months with that higher rate, and generally the interest rates fell considerably by mid-April or the latter part of April.

I do not feel, nor do many small business entrepreneurs that I have talked to, that SBA participating loans must be guranteed up to 90 pecent, nor do we understand the rationale or appropriateness of the points added to the prime rate. These bank guaranteed loans are of a quality nature which meet a critical standard established wherein the borrower has to meet special criteria of character, repayment ability, and credit worthiness. If he doesn't meet these criteria, the loan will not be guaranteed up to 90 percent.

Because of the high quality and low-risk nature of these loans, it is my recommendation that the SBA loan realistically should be a discounted loan instead of one with points added to it. I have brought this situation up many times with SBA officials, and on all occasions I have been told that to get banks to make these loans to small business entrepreneurs that they require a premium. I disagree.

We, the small business community, are paying an exorbitantly high rate for SBA participating loans. I would recommend that a more responsible rate would be one tied to the Treasury bill rate. Also, the procedure wherein interest rates are adjusted in relation to the prime on a twice-annual basis is extremely detrimental, especially in the volatile economy we have been experiencing in the last years.

When we acquired our initial $250,000 loan in 1975, the rate was established at 9¾ percent. When we paid the loan off in the fall of 1980, the rate was an astronomical 21½ percent. This does not save small business. It destroys it.

I have detailed the 10-year analysis depicting interest expense as a cost of doing business, that is an attachment that is on the back of my testimony. Also, I have charted the average inventory and operating expenses of my business, along with the interest after taxes, in the attachments. The figures on the charts graphically illustrate the deadly impact high interest rates have on our type of business. If you will look closely, you will find the interest expense as a percent of sales since 1970 has increased an overwhelmingly 436 percent—436 percent. Now, that really got me, too, when I figured it out, because there is labor and there are a lot of other things that are supposed to have been real, strong, overwhelming things to our business, but there is nothing to keep up with this interest expense of 436 percent.

I submit this family owned business is not any different than most businesses across America. We presently are charging 18 percent annual service charge on past-due accounts and we are paying 20 percent, and today we are paying 20½ percent—it went up a day ago—for our money, and legally the reason we are charging 18 is because in Missouri we could get into some problems charging higher than 18 percent to small business people that are not corporations.

Our firm survived a total destruction of buildings, equipment, and inventory in a 1974 fire, and we have endured a number of adversities. There are, and have been, many challenging problems confronting us, but high interest rates rank at the top.

Our firm has not contributed to its profit-sharing plan since 1978 and our employee morale is low. Further, we have filed for a 1980 tax refund on losses, and we are paying no estimated taxes this year. The U.S. Treasury is suffering, I submit, and this adds up to a miserably sick condition for small business and the free enterprise system as a whole in this country. And remember, unlike many new businesses which fail during the first 5 years, we are not a new, fledgling concern, but one that has weathered many cycles over the past two decades. A year ago we had 24 employees, today we have 17. We have cut back on costs in every conceivable way, and I mean every conceivable way. We even have our office people cleaning our office now, and that will give an illustration. We have no cleaning service. The small cleaning service people have suffered. We have had to cancel them. The coffee service people have suffered. We have had to cancel them, and the window cleaning service. It is right on down the line, just continuous right on.

For the past two decades small business' cut of the gross national product has been slipping. It has been reported recently that less than 40 percent of the GNP is attributable to small business. The high rates the small business community must pay for our capital requirements contributes to this decrease in the small business portion of the GNP. When I have confronted officials of the Federal Reserve Board, they indicate the money supply must be brought under control and we must fight inflation, and that small business is a special interest group and needs to consider the total picture. Small business is not a special interest group. It is the backbone of this economy. It is 95 percent of the business community. It is 24 times more innovative and it has been responsible for 7 million new jobs in the past 8 years. I submit the patient is dying with an incurable disease.

The problem of high interest rates for well established businesses is a serious problem; not because we cannot borrow money, but because small business is unable to pass on the added financial burdens and extra costs due to the excessively high interest rates. We don't mind paying taxes; it is the interest rates that are killing us.

The problem of money supply and credit is not the problem in this present situation of high interest rates. The problem is the tampering that the Federal Reserve System does by raising reserve requirements and establishing high broker rates and the many propping mechanisms used, as well as their apparent lack of control over the money supply. This artificial rate which is created falls most heavily on farmers, small business entrepreneurs, and the consumer, as these segments get their funding almost exclusively from banks. High interest in the long run fuels fires, and feeds inflation rather than depressing it.

This country cannot sustain this level of interest rates that we have. One of my biggest concerns with my clientele or my customer base that I sell in all these small, rural communities and suburbs in Kansas City and all around within 100 miles is the fact whether or not they are going to be able to rebound from this crunch that we have been in now in our business beginning 3 years this coming October. It started in October 1979. If these people cannot survive—you know, I can take the ups and downs if I am sure that in the future there are going to be a little bit better things coming, but if my clientele base, which are the small business people, cannot recover from the high interest rates that have been socked to them for the last 2 years, then I am out of business. Either that or I have to find some other vocation.

Small business is told to take it for the sake of lowering inflation, and at the same time big speculation continues to go on. We have been told repeatedly by the Federal Reserve we have got to take these interest rates in order to bring everything down, to get this inflation rate down, which is a bunch of hooey; and right in the middle of it the Hunt brothers debacle comes along and who bails them out? The Federal Reserve and a consortium of banks. Right now you read the paper every day, the Wall Street Journal, and you read about these giant takeovers and people coming down from Canada, and all of this, talking $4 billion and $5 billion worth of credit that has to be set up for Conoco. What do you think these guys are after Conoco for? Isn't it speculation? Isn't it because of the coal they have, or the oil reserves they have? That is pure speculation. If we had that $4 billion or $5 billion passed through the small business community throughout this country, then you would see jobs increase and you would see unemployment go down and you would see this economy come back.

Far too few Americans understand the impact the Federal Reserve has on each and every one of us. I challenge each of you to be responsible to understand it, and most importantly, to positively correct the inadequacies. Why is accountability from the Federal Reserve not demanded? Our monetary policy is killing the patient to cure the disease. Why aren't the billion dollar "buyouts" analyzed for what they are? Small business is told to take it for the sake of lowering inflation; at the same time big time speculation continues.

In my opinion, if the high rate of interest prevails for another 12 months, this country will be in a precarious position unlike any other time in history and will see massive bankruptcies. According to Dunn & Bradstreet, this year's projections reflect a doubling of failures. I call your attention to Inc. magazine, August 1981 issue—article attached. We are now seeing a burdensome number of closures and business bankruptcies and we will see this trend go out of control. It is not an unrealistic assumption that 25 percent of the farmers and agribusiness-related industries, and small businesses in this country could die in the next 12 months.

We aren't looking for special relief. When I am talking about small business, I am talking about all small businesses. I am not going to talk about housing. We have lobbyists that you can hear from every day about it. We need help. But all small business needs help.

The entrepreneur spirit and heritage in the small business community is proud and strong. The bankruptcy court is the court of last resort. Most of them will simply close their doors and fade away. They won't even become a statistic. I observe this as a day-to-day reality not only in the Midwest, but on a national scope.

One other thought that I have had after I wrote this, when I saw the article in the Wall Street Journal, and nothing against Mr. Cardenas or the SBA, but it made me mad when they are talking now about tying the SBA loans to the phony New York prime rate. That angered me, and as I thought about it coming back on the plane, my recommendation for a rate, for an honest to goodness honest rate that could be used, would be let the Federal Reserve in each one of the districts, they have the input, they know what the banks' average rate that they are loaning money for in their districts are, let that be the rate, rather than some area of the country where the money for some reason or another—in Kansas City right now, the prime rate there, our prime rate in Kansas City is something between 19 and 19½ percent interest, maybe, and New York is what—20½? So we apparently have a lower average prime going in Kansas City, so why tie a small businessman's loan in that part of the country to 20½ with points above it?

That is all I have to say. If you have any questions, I will be glad to answer them.

[Attachments to Mr. Piercy's testimony follow:]

	AVERAGE INVENTORY	OPERATING EXPENSE	INTEREST EXPENSE	INTEREST AS PERCENT OF SALES	SALES	PROFIT SHARING	INCOME AFTER TAX
970	$ 266,287	$195,644	$ 11,862	.67%	$1,759,171	$ 1,171	$ 27,447
971	340,028	298,833	12,533	.44%	2,853,678	10,033	42,755
972	519,226	403,039	21,643	.57%	3,769,254	17,725	52,648
973	749,585	509,906	30,543	.65%	3,709,189	31,919	55,044
974	479,103	440,112	43,590	1.37%	3,183,616	6,000	14,498
975	616,143	463,251	44,915	1.33%	3,369,806	4,000	6,764
976	774,298	603,083	53,074	1.09%	4,874,410	15,000	53,276
977	930,531	736,317	61,913	1.01%	6,143,020	50,494	87,330
978	1,031,533	804,918	83,693	1.11%	7,519,887	40,966	112,617
979	898,132	877,004	141,315	1.97%	7,182,010	9,782	18,158
980	1,055,665	840,172	157,564	2.92%	5,389,164	-0-	(99,313)

Explanation for Charts:

1. Interest expense is included in the total operating expense. It is easy to see when the Federal Reserve Board's high interest rate policy took over. As you can see, the firm has experienced a 436% increase in interest expense, as a percent of sales since 1970.

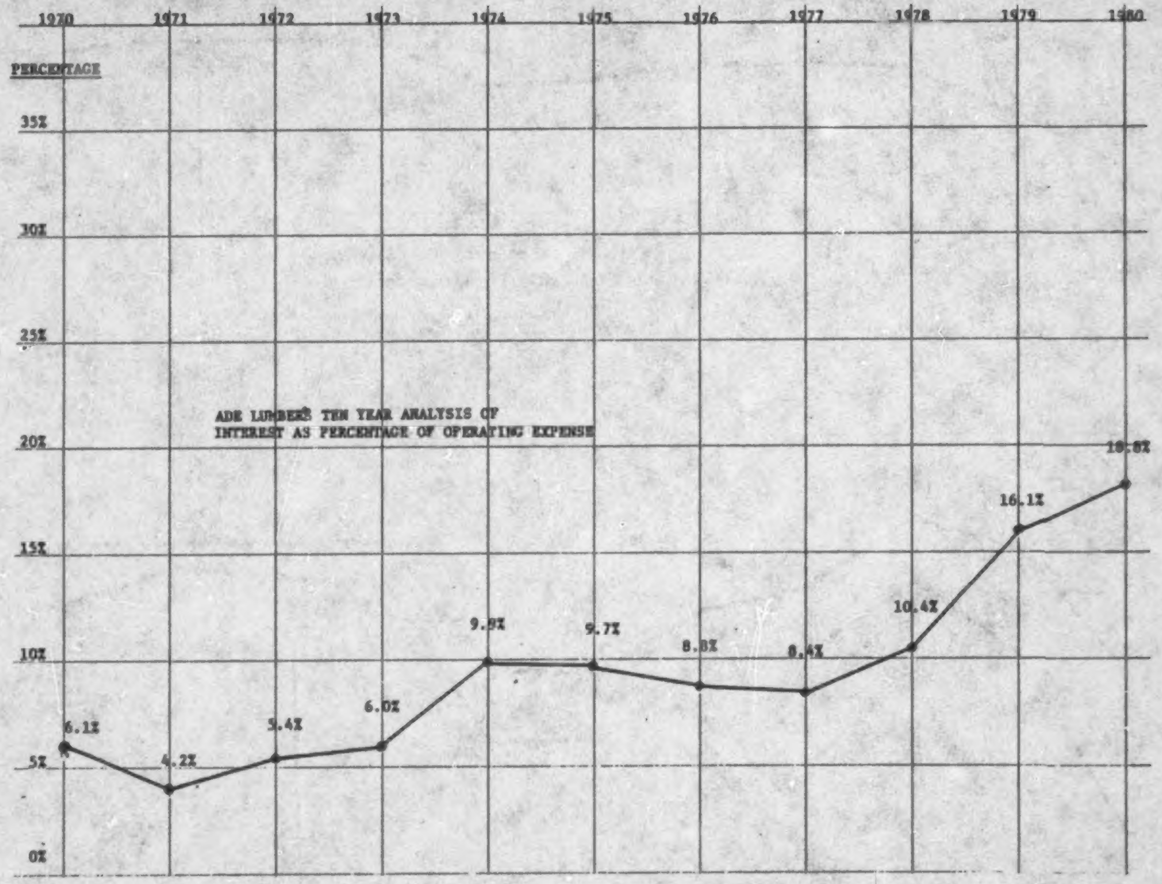
2. As a wholesale/supplier the firm's business is to sell building materials. 50% of the firm's sales are comprised from commodity wood products, i.e., dimensional lumber and plywood, and the prices have deteriorated with business slippage. The mill shippers have cut the prices most recently. The firm's remaining 50% of its business sales are in specialty products: roofing, metals, nails, prefinished paneling, etc.

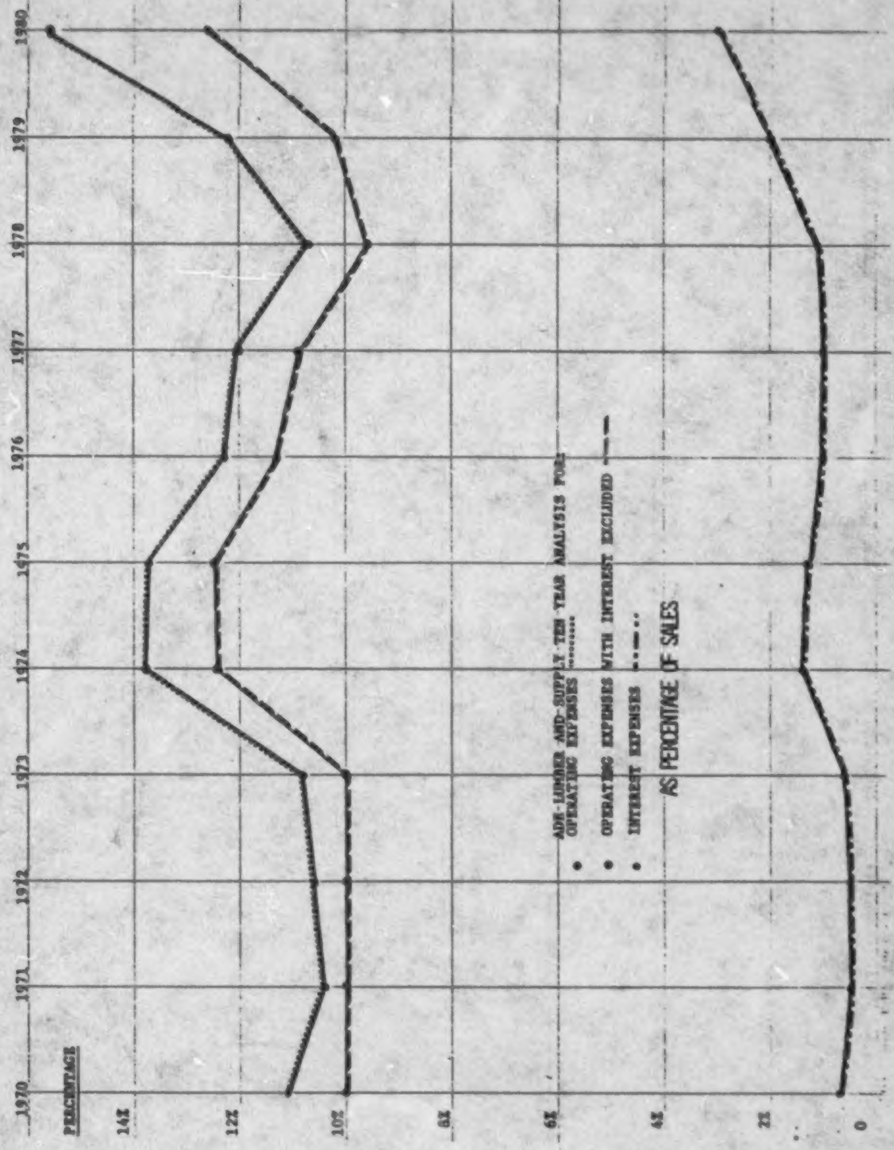
   When the firm liquidates inventory, the firm is "out of business." The year to date trend is down as it has been for the past 19 months with the firm operating in the red. Unlike many businesses, in the lumber industry it is impossible to get inventory down in less than six months to a year. Once the supplier places the order, it is not possible to cancel the order. The 90-day order cycle for lumber and materials purchased from the mill requires 6 months to a year's time to effect the inventory reduction. In a down cycle, to effect the necessary reduction is impossible.

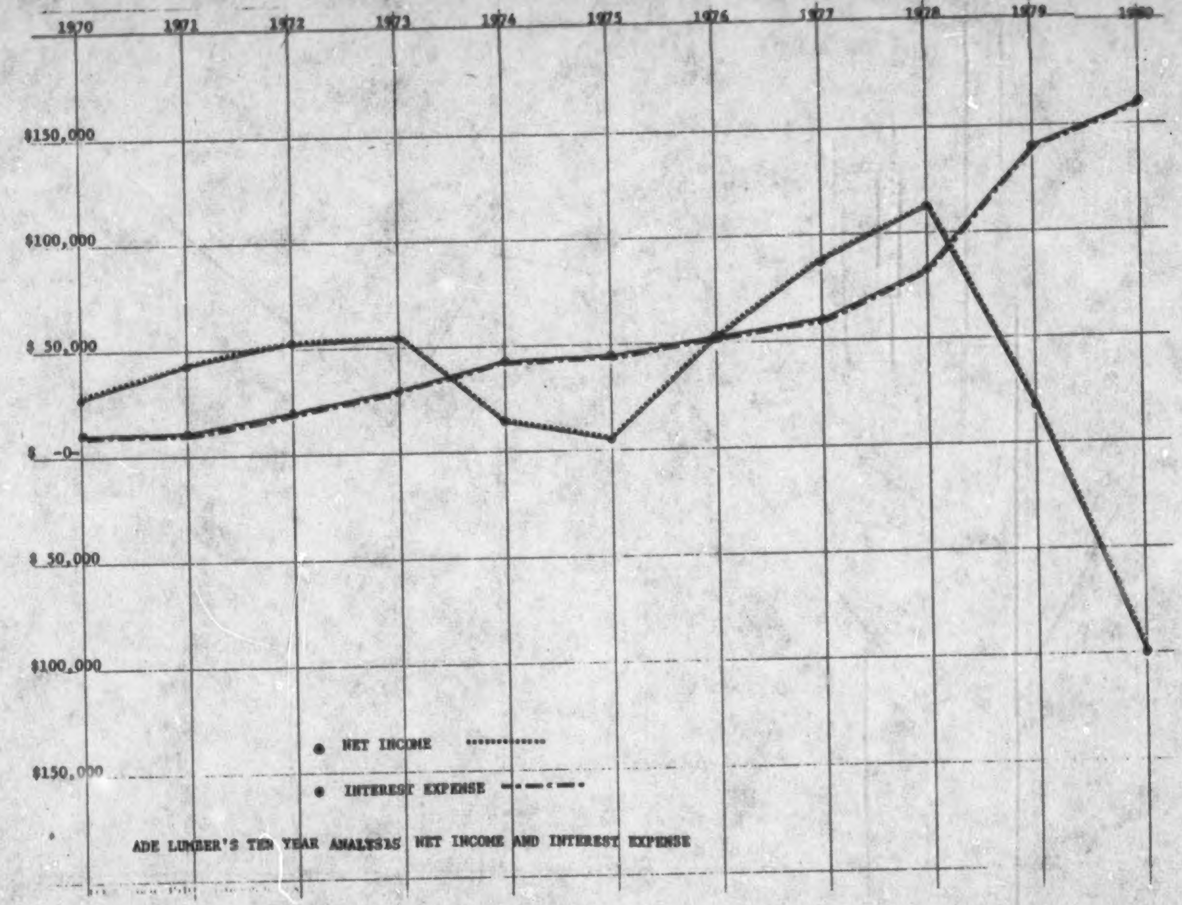
   Although the firm cut losses, it has been possible only by releasing long-tenure employees, selling equipment, reducing inventory and reducing services.

3. In 1980, big businesses operating within the lumber and building materials industry have chosen to reduce the profit margins and have shown "open movement" to curtail competition and selling products at A-D-E's actual cost to buy inventory, therefore, A-D-E's gross margins are down.

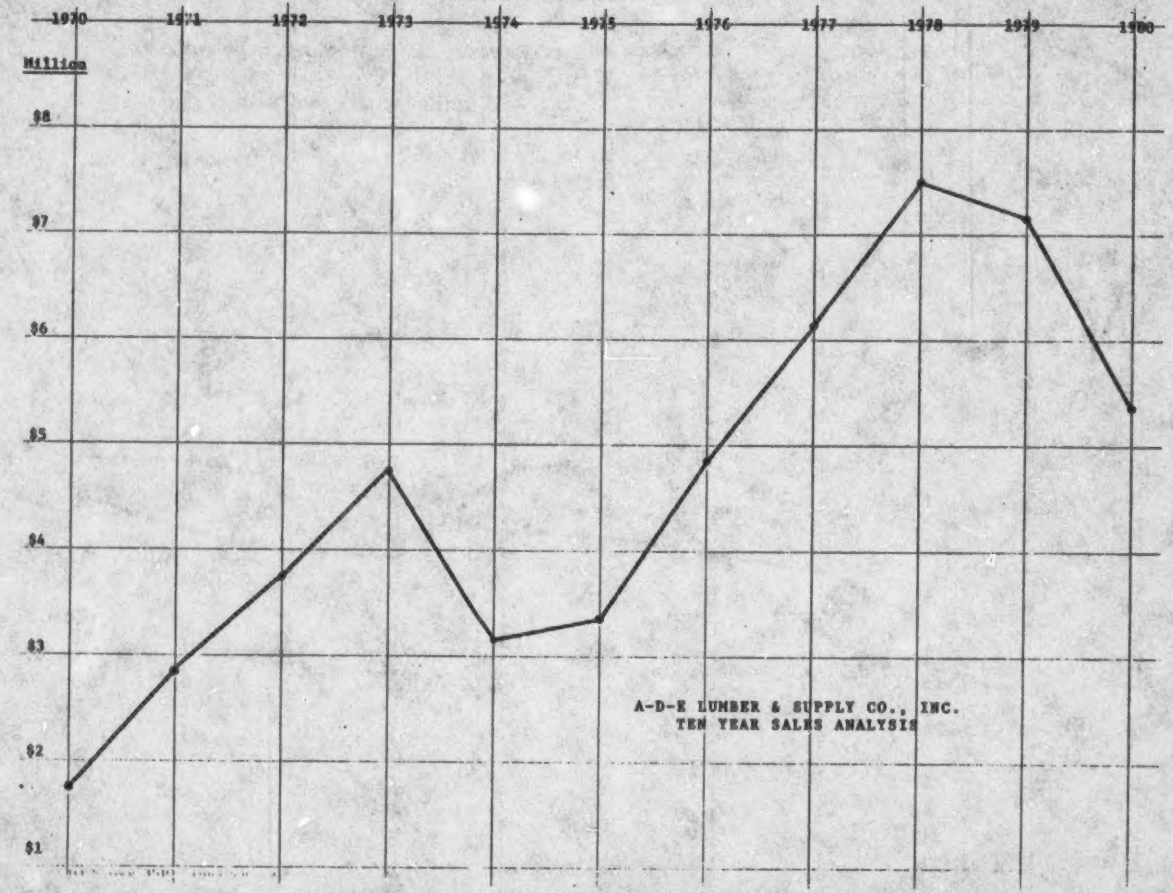
   In 1974, the firm experienced a devastating fire which totally destroyed the buildings, inventory, equipment and materials acquired over the first 15 years of business. Insurance did cover replacement of buildings and equipment, but did not allow the firm to replace the same equipment without considerable additional investment. For example, the firm acquired five replacement forklifts (new), which were approximately twice the original purchase price.


ADE LUMBER'S TEN YEAR ANALYSIS OF
INTEREST AS PERCENTAGE OF OPERATING EXPENSE
PERCENTAGE
35%
30%
25%
20%
15%
10%
5%
0%
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
6.1%
4.2%
5.4%
6.0%
9.8%
9.7%
8.8%
8.4%
10.4%
16.1%
18.3%


ADM-LUMBER-AND-SUPPLY TEN-YEAR ANALYSIS FOR:
• OPERATING EXPENSES ....
• OPERATING EXPENSES WITH INTEREST EXCLUDED ——
• INTEREST EXPENSES .—.
AS PERCENTAGE OF SALES
PERCENTAGE
14%
12%
10%
8%
6%
4%
2%
0
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980



ADE LUMBER'S TEN YEAR ANALYSIS NET INCOME AND INTEREST EXPENSE



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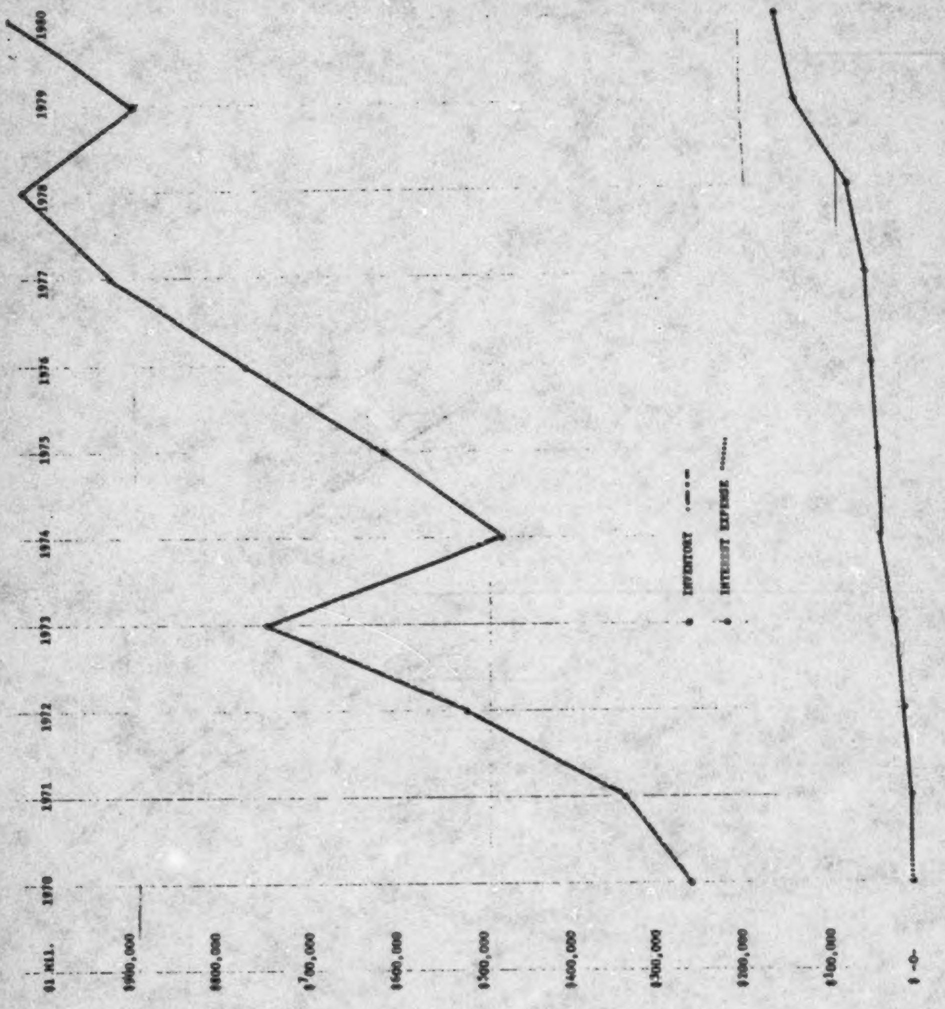
TEN YEAR SALES ANALYSIS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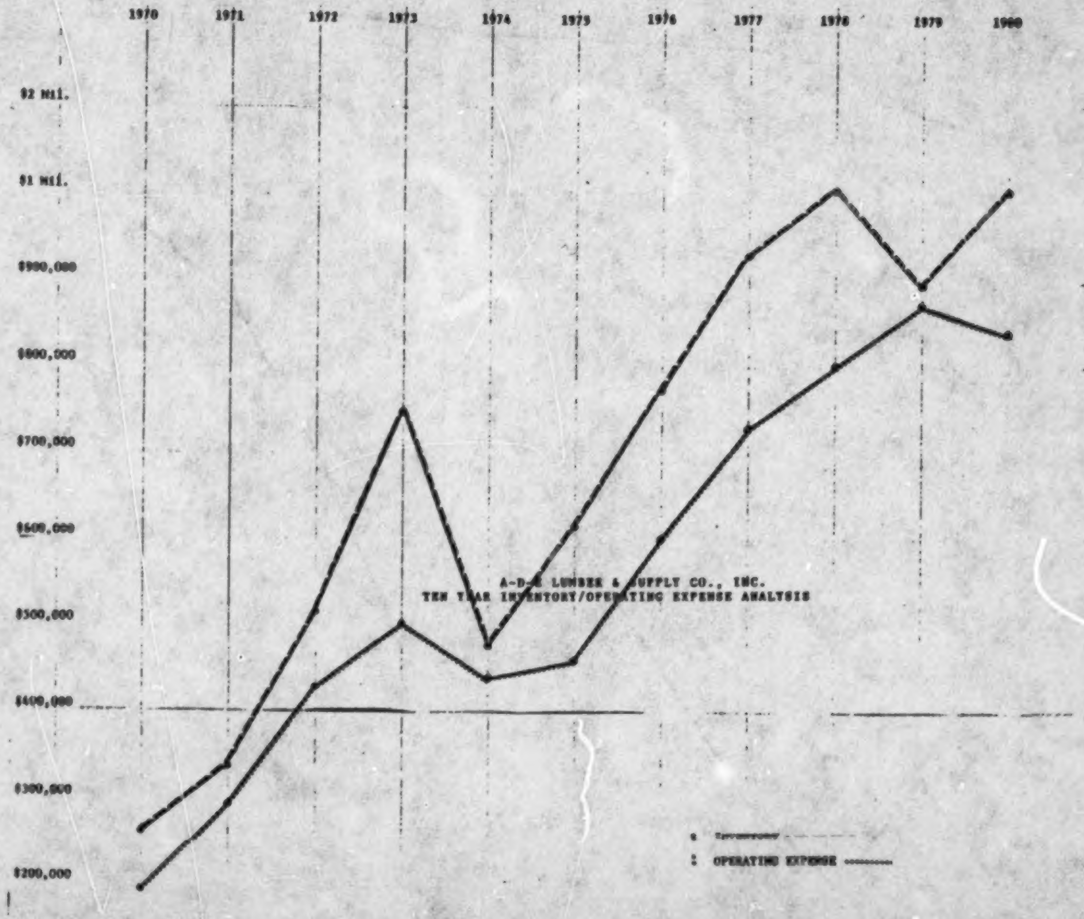
A-D-A LUMBER & SUPPLY CO., INC.
TEN YEAR INVENTORY/OPERATING EXPENSE ANALYSIS

OPINIONS

POLLSTERS FIND SMALL BUSINESS PESSIMISTIC

If you believe the findings of a lot of the polls of small business people and surveys of chief executive officers these days times are tough.

A recent nationwide Heller/Roper Small Business Barometer poll reports, for instance, that inflation continues to "plague small business." The majority of the CEOs queried feel their cost of doing business has increased more than the general rate of inflation. The smaller the company, the bigger the problem seems: 57% of companies with 40 to 99 employees said costs had risen faster than the inflation rate, compared with 49% of those with 100 to 299 employees and 41% of those with 300 to 499 employees.

(a) Regional polls report equally gloomy results. A Small Business Service Bureau Inc. poll of its 30,000 members throughout the Northeast revealed that 40% of the respondents believe "the climate for small business will deteriorate over the next decade."

(b) Gloomiest of all was a poll by Atlanta-based Systematic Business Research Inc. that found more than 60% of small businessmen say they will close down by the end of the year if interest rates don't go down. The most pessimistic CEOs were in retailing and real estate, businesses that are hit particularly hard by high interest rates.

Such polls have to be taken "with at least a grain of salt," cautions Julie Nickerson, vice-president of the First

NEWS & TRENDS (from page 21)

National Bank of Boston, which, along with the Smaller Business Association of New England, conducts monthly small business polls. "We are measuring what CEOs feel about their businesses," Nickerson comments. "The polls aren't reporting hard data."

REGULATION

ENFORCING REGFLEX: WILL THE SBA BE AGGRESSIVE?

A battle is brewing in Washington over the Regulatory Flexibility Act, which requires federal agencies to prepare analyses of rules they think will have an impact on small businesses. The primary issue is which rules are subject to "regflex" review and which are exempt.

The Internal Revenue Service, for instance, maintained in its first regflex agenda that only 2 of its 287 proposed rules were subject to regflex analysis. The IRS claims the other 285 rules interpret congressional intent and therefore are not subject to regflex analysis, which is required only for "legislative" rules issued by agencies—rules considered substantive additions to the law.

The Department of Defense, the General Services Administration, the Office for Procurement Policy, and the National Aeronautics and Space Administration also have claimed that their procurement regulations aren't covered by the act.

Regflex, passed last fall, was designed to force federal agencies to consider the impact their rules would have on small businesses. Under the act, agencies are required to identify which of their proposed regulations will affect small businesses and to assess in a separate report exactly what the effect will be.

Mr. **LaFalce**. Thank you very much for your excellent testimony. If we have any questions, we will take them later.

I would now like to call on Mr. William Bolt, of Kansas City, Mo.

TESTIMONY OF WILLIAM BOLT, VICE CHAIRMAN, UNITED MISSOURI BANK, KANSAS CITY, MO.

Mr. **Bolt**. Thank you.

While Mr. Piercy and I are both from Kansas City, we unfortunately do not have his account with our bank so there is no collusion between the two of us. I want to assure you of that.

It is with pleasure that I appear before you today to discuss interest rates charged to business, with particular emphasis on the so-called prime rate. Currently, I serve as vice chairman of the United Missouri Bank of Kansas City, in charge of all lending activities. United Missouri is the largest bank in the Metropolitan Kansas City area, and the lead bank of a 21-bank holding company with locations throughout the State of Missouri. Total assets of the holding company exceed $2.2 billion, and United Missouri Bank of Kansas City's assets exceed $1.4 billion.

Our bank serves the full range of business, from the largest corporations in the country to the smallest of businesses. While we serve many consumer borrowers, on a holding company basis over 65 percent of our loans are to business and agricultural entities. We have concentrated our business lending on a local and regional basis, with particular emphasis on the growing and embryo businesses.

A number of our business customers who now borrow in the million dollar amounts started with loans of $20,000 or less. We have seen what industrious, well-managed, and properly financed businesses can achieve. The vast majority of our business customers are owner managed, and in a number of cases, we currently have third-generation owner management as our continuing customers. As an adjunct to this, quite often our role is to provide financing to new owner management on a buyout from present owners. We provide the full range of business loans—accounts receivable, inventory, equipment, land and buildings—and as a result, feel quite qualified to measure the needs and problems of the business community.

In April 1980, we found ourselves, along with the rest of the banking community, at a prime rate of 20 percent. We knew the pressures this was placing on many of our customers. Quite frankly, there are a number of businesses, particularly those who are relatively young in tenure and in a growth mode, that cannot absorb such a rate and survive. We thus decided to adopt a posture of attempting to keep the prime rate of our bank at a level lower than the prime quoted by money center banks as long as interest rates remained at the then high levels.

We have pursued that course over the last 16 months, with the maximum differential being 1¾ percent below the nationally quoted prime rate. Our quoted prime rate was our base and the lowest rate given to any business customer on business loans. We have made no exceptions and have done no subprime lending such as was conducted by a number of other banks. At the same time, many businesses whose rates were, for example, 2 percent over prime, were lowered to 1½ percent over, or similar type reductions. On the other hand, we found that some of our larger borrowers, which in proportion are less expensive to serve, were obtaining funds at lesser rates than our prime rate, and even further below the stated prime rate of the banks which were supplying the funds. In several instances, we found larger customers receiving loans at 3 percent or more under prime when they had no account or other relationship with the bank providing the funds.

Obviously, this represented an attempt to woo away our most lucrative customers. While we were tempted to meet the rates, we felt that this would be unfair and inequitable to the majority of our customers. We refused to make any exceptions and continued the policy of keeping our prime at a level lower than other banks. A number of our larger customers respected our position and supported us by maintaining larger balances. We also publicly stated our position and questioned what the prime really was.

We still believe in the prime rate as we administer it. In our opinion, it is the only way we can be fair to all of our customers. We also believe this approach says what we really feel: That current rates are too high and too burdensome to many businesses. We are in sympathy with them and are doing what we can to lower their interest costs.

Members of this committee, I say to you, we are financing the people and businesses that made this country great; and they need respite from what has occurred to them in interest costs over the last 2 years. Many of them are right at the end of their rope. I think you heard that earlier.

It is my understanding that you are interested in our approach to loans guaranteed by the Small Business Administration. We have been an active participant in the program and are one of two banks in the Kansas City area in the certified lenders program. Currently, 75 percent of our active SBA loans are on a fixed-rate basis at rates ranging from 7¼ percent to 18½ percent. Until 3 months ago, the prime used for the base was the quoted prime for New York banks in the Wall Street Journal. We now have received permission to use the prime of another local bank that typically tracks our prime for a base—as long as it is less than the Wall Street quoted prime.

We have not sold off any of the guaranteed portions of our loans, but our bond department actively sells guaranteed portions on behalf of a number of our correspondent bank customers. These are typically smaller banks in Kansas and Missouri who handle SBA loans and do need the relief in the ability to sell off those guaranteed portions.

A further point that may interest you is that since March 1980 we have called on the SBA to honor the guarantee on only 2.6 percent of the dollar amount of our disbursed loans. I caution you that this figure will increase greatly over the next 12 months if we do not see relief to a measurable extent in the current high interest rates. Quite simply, all the fat has been dissipated.

Thank you.

[Attachment to Mr. Bolt's statement follows:]

SBA LOAN NUMBER
2-257 024 30 10-KC

NOTE

Kansas City, Missouri
(City and State)

$ 250,000.00

(Date) 5 Sept, 19 75

For value received, the undersigned promises to pay to the order of ________________

________________ (Payee)

at its office in the city of Kansas City, State of Missouri

or at holder's option, at such other place as may be designated from time to time by the holder ________________

TWO HUNDRED FIFTY THOUSAND AND 00/100 -- dollars.
(Write out amount)

with interest on unpaid principal computed from the date of each advance to the undersigned at the rate of 9 3/4 per cent

per annum, payment to be made in installments as follows:

$4,600.00, including principal and interest, payable monthly, beginning one (1) month from date of Note, and the balance of principal and interest payable six (6) years from date of Note. PROVIDED, each said installment shall be applied first to interest accrued to the date of receipt of said installment, and the balance, if any, to principal.

Undersigned further agrees that, after two full calendar quarters subsequent to the date hereof, the rate of interest herein shall increase or decrease at an equal percentage per annum as the American Banker, Prime Rate, which is a published rate, changes, to be effective as of April 1 and October 1 in each year, and the change in the rate of interest herein shall be determined and become effective as of April 1 and October 1. Holder shall give written notice to SBA and the undersigned of each increase or decrease in the interest rate pursuant hereto, within 10 days after the effective date.

If the undersigned shall be in default in payment due on the indebtedness herein and the Small Business Administration (SBA) purchases its guaranteed portion of said indebtedness, the rate of interest on the unguaranteed portion herein shall become fixed at the rate in effect as of the initial date of default. If the undersigned shall not be in default in payment when SBA purchases its guaranteed portion, then the rate of interest on the unguaranteed portion herein shall be fixed at the rate in effect as of the date of purchase by SBA.

Payment of any installment of principal or interest owing on this Note may be made prior to the maturity date thereof without penalty.

The term "Indebtedness" as used herein shall mean the indebtedness evidenced by this Note, including principal, interest, and expenses, whether contingent, now due or hereafter to become due and whether heretofore or contemporaneously herewith or hereafter contracted. The term "Collateral" as used in this Note shall mean any funds, guaranties, or other property or rights therein of any nature whatsoever or the proceeds thereof which may have been, are, or hereafter may be, hypothecated, directly or indirectly by the undersigned or others, in connection with, or as security for, the Indebtedness or any part thereof. The Collateral, and each part thereof, shall secure the Indebtedness and each part thereof. The covenants and conditions set forth or referred to in any and all instruments of hypothecation constituting the Collateral are hereby incorporated in this Note as covenants and conditions of the undersigned with the same force and effect as though such covenants and conditions were fully set forth herein.

The Indebtedness shall immediately become due and payable, without notice or demand, upon the appointment of a receiver or liquidator, whether voluntary or involuntary, for the undersigned or for any of its property, or upon the filing of a petition by or against the undersigned under the provisions of any State insolvency law or under the provisions of the Bankruptcy Act of 1898, as amended, or upon the making by the undersigned of an assignment for the benefit of its creditors. Holder is authorized to declare all or any part of the Indebtedness immediately due and payable upon the happening of any of the following events: (1) Failure to pay any part of the Indebtedness when due; (2) nonperformance by the undersigned of any agreement with, or any condition imposed by, Holder or Small Business Administration (hereinafter called "SBA"), or either of them, with respect to the Indebtedness; (3) Holder's discovery of the undersigned's failure in any application of the undersigned to Holder or SBA to disclose any fact deemed by Holder to be material or of the making therein or in any of the said agreements, or in any affidavit or other documents submitted in connection with said application or the Indebtedness, of any misrepresentation by, on behalf of, or for the benefit of the undersigned; (4) the reorganization (other than a reorganization pursuant to any of the provisions of the Bankruptcy Act of 1898, as amended) or merger or consolidation of the undersigned (or the making of any agreement therefor) without the prior written consent of Holder; (5) the undersigned's failure duly to account, to Holder's satisfaction, at such time or times as Holder may require, for any of the Collateral, or proceeds thereof, coming into the control of the undersigned; or (6) the institution of any suit affecting the undersigned deemed by Holder to affect adversely its interest hereunder in the Collateral or otherwise. Holder's failure to exercise its rights under this paragraph shall not constitute a waiver thereof.

SBA FORM 147 (8-71) REF: SOP 50 10 PREVIOUS EDITIONS AND SBA FORMS 156, 156A, 530 AND 530A ARE OBSOLETE

1972 loan

Borrower

SBA LOAN NUMBER
SBLG-21S.514 10 06-KC

NOTE

Kansas City, Missouri
(City and State)

$ 150,000.00 (Date)____________, 19____

For value received, the undersigned promises to pay to the order of ____________
____________ (Payee) ____________
at its office in the city of Kansas City, State of Missouri,
or at holder's option, at such other place as may be designated from time to time by the holder One Hundred Fifty Thousand and no/100 ——————————— dollars,
(Write out amount)

with interest on unpaid principal computed from the date of each advance to the undersigned at the rate of ________ percent per annum, payment to be made in installments as follows:

Five (5) years from the date of Note, with interest at the rate per annum hereinafter provided on the unpaid principal, and equal installments including principal and interest each in the amount of $3,006.00 payable monthly, beginning one(1) month from the date of Note, and the balance of principal and interest payable five (5) years from the date of Note.

The interest rate on this loan as of the date hereof is seven and one-half percent (7½%) per annum.

The undersigned further agrees that, after two (2) full calendar quarters subsequent to the date hereof, the rate of interest herein shall increase or decrease at an equal percentage per annum as the rate changes in the maximum interest rate permitted by SBA for guaranteed loans, as published by SBA in the Federal Register to be effective as of January 1 and July 1 in each calendar year, and the change in the rate of interest herein shall be determined and become effective as of said January 1 and July 1. Holder shall give written notice to the undersigned of each increase or decrease in the interest rate pursuant herein, within ten (10) days after the effective date thereof.

If the undersigned shall be in default in payment due on the indebtedness herein and Small Business Administration (SBA) purchases its guaranteed portion of said indebtedness, the rate of interest herein shall become fixed at the rate in effect as of the initial date of default. If the undersigned shall not be in default in payment when SBA purchases its guaranteed portion, then the rate of interest herein shall be fixed at the rate in effect as of the date of purchase by SBA.

Payment of any installment of principal or interest owing on this Note may be made prior to the maturity date thereof without penalty.

The term "Indebtedness" as used herein shall mean the indebtedness evidenced by this Note, including principal, interest, and expenses, whether contingent, now due or hereafter to become due and whether heretofore or contemporaneously herewith or hereafter contracted. The term "Collateral" as used in this Note shall mean any funds, guaranties, or other property or rights therein of any nature whatsoever or the proceeds thereof which may have been, are, or hereafter may be, hypothecated, directly or indirectly by the undersigned or others, in connection with, or as security for, the Indebtedness or any part thereof. The Collateral, and each part thereof, shall secure the Indebtedness and each part thereof. The covenants and conditions set forth or referred to in any and all instruments of hypothecation constituting the Collateral are hereby incorporated in this Note as covenants and conditions of the undersigned with the same force and effect as though such covenants and conditions were fully set forth herein.

The Indebtedness shall immediately become due and payable, without notice or demand, upon the appointment of a receiver or liquidator, whether voluntary or involuntary, for the undersigned or for any of its property, or upon the filing of a petition by or against the undersigned under the provisions of any State insolvency law or under the provisions of the Bankruptcy Act of 1898, as amended, or upon the making by the undersigned of an assignment for the benefit of its creditors. Holder is authorized to declare all or any part of the Indebtedness immediately due and payable upon the happening of any of the following events:
(1) Failure to pay any part of the Indebtedness when due; (2) nonperformance by the undersigned of any agreement with, or any condition imposed by, Holder or Small Business Administration (hereinafter called "SBA"), or either of them, with respect to the Indebtedness; (3) Holder's discovery of the undersigned's failure in any application of the undersigned to Holder or SBA to disclose any fact deemed by Holder to be material or of the making therein or in any of the said agreements, or in any affidavit or other documents submitted in connection with said application or the indebtedness, of any misrepresentation by, on behalf of, or for the benefit of the undersigned; (4) the reorganization (other than a reorganization pursuant to any of the provisions of the Bankruptcy Act of 1898, as amended) or merger or consolidation of the undersigned (or the making of any agreement therefor) without the prior written consent of Holder; (5) the undersigned's failure duly to account, to Holder's satisfaction, at such time or times as Holder may require, for any of the Collateral, or proceeds thereof, coming into the control of the undersigned; or (6) the institution of any suit affecting the undersigned deemed by Holder to affect adversely its interest hereunder in the Collateral or otherwise. Holder's failure to exercise its rights under this paragraph shall not constitute a waiver thereof.

Mr. **LaFalce**. Thank you very much, Mr. Bolt.

We would now like to call on Mr. Jack Kleiner, an attorney from Kleiner & Merren in Atlanta, and also a business professor who has brought lawsuits, I understand, questioning the validity of the use of the prime rate.

Mr. Kleiner.

TESTIMONY OF JACK KLEINER, ATTORNEY AT LAW, KLEINER & MERREN, ATLANTA, GA., AND BUSINESS PROFESSOR, GEORGIA TECH

Mr. **Kleiner**. Thank you, Mr. Chairman. I now know how Diogenes must have felt with his lantern looking for that honest person. To my right I have found an honest banker. Sir, I want to commend you.

I think the major problem that we have today is the accuracy of the prime rate, and let me address my remarks to that.

Historically, when we have heard about the prime rate we have thought of it as being the best rate given by the banking community to their most credit worthy customers. It is interesting to note that the prime rate was formally adopted by the banking community in the year 1933, the same year I was born. Why was it adopted in 1933? Why was it necessary? Simply because the banking community had very few credit worthy commercial customers out there in this great country of ours. There was a great depression, and the banking community wanted to avoid cutthroat competition in order to deal very selectively with their best customers.

What has happened, though, is over the years the banking community has stopped using the prime rate as a true barometer for the loans to be made to their most credit worthy customers. Now it is somewhat ironic, in this era of below-prime-rate lending, that the banking community argues that we need below-prime-rate lending in order to keep their most credit worthy commercial customers. We will lose them, they say the great bugaboo is foreign banks coming here and making loans when they are not under the same reserve requirements as our U.S. banks are.

Another one is: What can we do about all of these big corporations selling their own commercial paper to the business community and the public at large at rates below the prime? After all, suppose a large corporation says to that big bank, "If you don't give me a discount, I am going to leave you. Either I am going to that bank across the street or I am going to sell my paper to the public."

Now, gentlemen, what would your paper and my paper be worth if sold to the public? I don't think it would be worth a great deal. So consequently we are all like small business people, every one of us, not just consumers, but small business people. We can't go into a bank and expect that bank to give us a good deal because the bank cannot afford to do it. I understand the reasons why the banking community has to make profits. They have to answer to stockholders just like other corporations do.

That isn't the issue. The issue is: Have they been telling the truth? The prime rate is phony; it is a fraud. We have alleged that in our lawsuits and we proved it before one jury. We have had one trial where a jury in Kentucky came back and said:

> This businessman has been cheated. The bank said they were giving him the best rate. They are not giving him the best rate. Therefore, we need to adjust his interest cost downward to something closer to the true lowest rate.

The banking community is playing very fast and loose with us here on that prime rate. The banking community at one time used commercial paper, 90-day commercial paper sold in the market, as linkage to its prime rate. They were very careful to say that, "We have to charge something over and above the commercial paper in order to make a profit." So be it. But the banking community discovered that when double-digit inflation came about in the seventies, the late seventies, that they couldn't make a profit using commercial paper for linkage so they discarded it. Now they use something that they call the cost of money. And this is documented.

The Bank of America says:

> Because the bank uses money from various sources to make its loans, the interest rate on each loan reflects the amount the bank itself must pay to use the money. The best barometer of interest rates is the prime rate, the lowest interest rate that an individual bank charges for short-term loans to its biggest and most credit worthy customers.

How in the world can it be the lowest when they are making loans at below prime rates? Is there a better than best? If there is, then the English language has changed way beyond my comprehension. And that is the real issue here. I know that small businesses are virtually powerless to combat the banking community. They are not as organized as the banking community and they don't have the tremendous special interest lobbying for pressure that can be put on Congress. The bankers are advisers to the Government. There aren't that many small businessmen who are advisers to the Government.

Now, as circumstances would have it, I ended up personally borrowing at prime plus one from my own bank in Atlanta, the First National Bank of Atlanta, and lo and behold, I discovered that that bank was making below-prime-rate loans. I didn't know that such an animal existed as below-prime-rate loans. I started making inquiries. I discovered that this is a prevalent practice in the banking community. In fact, Federal Reserve data will show you that, in dollar volume, the largest number of commercial loans on the books of the leading commercial banks in this country at one time was below-prime-rate loans; not prime rate, not above prime rate.

That is all it took for me to file a lawsuit. I felt I had to file the suit on my own behalf because if I didn't sue, nobody else was going to sue. Why wouldn't a small business person file a suit against the bank? Why wouldn't some banks lower their interest cost to small business people below prime? The answer is fairly obvious: Fear. You cannot step out of line. If you are a small business person, you have very limited resources in which to get credit. If you are a small bank, you are worried about what it will cost you later on to borrow from the larger banks.

The banking community, I think, has gotten together and decided this is a very effective way of making profits to subsidize the losses that occurred during the real estate fiascoes in the midseventies. I can't prove that. There is no smoking gun. I don't have any evidence that the bankers get together at the American Bankers Association and say, "Hey, it's your turn today to set the prime rate. It will be my turn next week." They are much too clever. I cannot prove that and I don't have to prove it, because Congress has given me a weapon. It is called the Racketeer Influence and Corrupt Organizations Act. How do you like that? Bankers are racketeers. Oh, they love that. I mean, after all, when we think of racketeers, we think of, I guess, narcotics, prostitution. So what? I am talking about the pushers and panderers of phony prime. They are racketeers. Maybe they are white-collar racketeers, but they are still racketeers.

I think when the banking community begins to realize that there are a lot of people as agitated as I am, something is going to happen. This committee wants to come up with some kind of a benchmark to give credence to the guaranteed loan program of the SBA. Well, I would hope that with all your might, you resist the prime rate as being a benchmark. It isn't an indicator of anything. It is a rigged barometer. You have the banking community using the house dice, and how many of you get a fair shake when you use someone else's loaded dice?

We have a real problem out there. We have the banking community who are being told by the Federal Reserve that high interest rates are good for the economy. After all, they are going to get rid of us undesirables. Hey, I don't like being called an undesirable. The banking community feels that if you use high interest rates, you are really using a very effective tool to cure inflation. Well, that is about as effective as having the patient killed to cure the illness. What do the bankers care? They are not the patients. That is really the answer.

I feel very strongly that if you allow the banking community to continue using the prime rate, they will continue to play games with it. I don't think there is any justification for prime. None of us here should feel that they have a right to call something best and then to make loans that are better than best.

Let me pull out something that I found shocking. It happens to come from a note that was offered to a businessman who had enough sense to read it, bring it to his lawyer, and not sign it. This comes from a bank. I will read you the note.

> The undersigned understands that the bank has more than one established "best rate" and that as used herein, such term shall mean the highest established prime interest rate charged by the bank to large commercial customers.

If that isn't a license to steal, I don't know what is. I am not going to reveal the name of the bank so as to protect the guilty, but I will move on.

I feel that we have, in the marketplace, very good benchmarks. We have in this great economy of ours a free marketplace, and among those benchmarks are 13-week Treasury bills, 26-week Treasury bills, 7-year Treasury notes, and they aren't rigged. This is all legitimate. Why can't the banking community simply restrict itself to one of those legitimate benchmarks? Why can't the SBA see itself in the position of the small business constituency that they represent; namely, that these people out there need help, and they just don't need the banking community calling the shots on them.

I will conclude simply by saying that if you let the banking community make the rules for the small business community, you are not going to have a small business community in the future.

Thank you.

[Mr. Kleiner's prepared statement follows:]

Prepared Statement of Jack Kleiner, Attorney at Law, Kleiner & Merren, Atlanta, Ga., and Business Professor, Georgia Tech

ACCURACY OF THE PRIME RATE

Historically, the prime rate has been the best rate given by banks to their most credit-worthy customers. Beginning with the year 1933, the same year I was born, the banking industry formally adopted a prime rate in order to avoid cut-throat competition and to prevent banks from making below prime rate loans to those few credit-worthy customers left in this country at the time of the Great Depression. It is somewhat ironic that the banking industry now uses the argument that below prime rate loans are necessary in order to keep their most credit-worthy customers satisfied and to avoid cut-throat competition.

Before the era of double digit interest rates, commercial banks would give their best customers the prime rate and the rest of the business community would be required to pay something over and above that. After the arrival of double digit interest rates, banks began to make below prime rate loans. At one time, there were more commercial loans in terms of dollar volume on the books of banks at rates below the prime rate than at rates at prime or above, according to the Federal Reserve. In Atlanta, Georgia, one large corporation has a line of credit with the First National Bank of Atlanta where it pays five points below the prime rate, and that's clearly not the exception to the rule.

As reported by the Committee on Small Business of the United States House of Representatives on September 30, 1980 in a Report entitled "Federal Monetary Policy and Its Effect on Small Business", page 20 footnote 30, the accuracy of the prime rate as a benchmark for the lowest rate charged by banks to their best customers really depends upon the underlying formulas used by the banking industry. According to Paul A. Volker, Chairman of the Federal Reserve Board, the banking industry used a linkage of prime rates to money market rates until the late 1970's. At one time the money market indicator used was the ninety (90) day commercial paper rate and, at another time, the money market indicator used was the ninety (90) day certificate of deposit rate. Mr. Volker further stated, ". . . however, banks abandoned such formulas, . . . As a result, an unprecedented gap has opened between the prime rate and money market rates."

The current linkage to the prime rate is supposed to be related to some measure of the bank's cost of funds. This premise is confirmed by no less an authority than the Bank of America's Small Business Reporter, October 1980, Volume 14, Number 10, page 11, which states:

"Because the bank uses money from various sources to make its loans, the interest rate on each loan reflects the amount that the bank itself must pay to use the money."

The Bank of America further states:

"Interest rates on short-term loans fluctuate according to the interest paid on short-term deposits, which in turn depends on conditions in the money-market—the supply and demand for short-term funds. The *best barometer of interest rates* on all short-term borrowings *is the prime rate,* the lowest interest rate that an individual bank charges for short-term loans to its biggest and most creditworthy customers." [emphasis added]

So, we have a barometer where the mercury is rigged, in my opinion. The best barometer of interest rates is not the prime rate. The banking industry has decided that this is a good time to make up for some of the bad times banks had in previous years and, particularly, when they lost a lot of money in real estate deals. The banks know that the small business community is virtually powerless to combat the phony prime rate. It is truly an artificial rate. I consider it a fraud.

The quote attributed to me in The Wall Street Journal of Friday, November 7, 1980, is accurate: "The banks artificially created the prime to make higher profits and then artificially discounted it . . . . They are white collar criminals in three piece suits."

I don't see any difference between what the banking industry is doing and what loan sharks in the past have done. They used to put people in prison for charging those kinds of rates. Congressman Charles A. Lindbergh, the father of "Lucky

Lindy", stated on the floor of the United States House of Representatives some fifty years ago: "In that dark crew of financial pirates there are those that would cut a man's throat to get a dollar out of his pocket." He was speaking about the banking industry!

We do know that banks who cheat their borrowers are vulnerable and that a jury will not hesitate to do what is right. In the case of *Bardstown Shopping Center, Inc. vs. United Kentucky Bank,* decided on June 26, 1981, the jury adjusted downward the interest charges of a small business so as to be closer to the true lowest and best interest rate; that jury was presented with clear and convincing evidence that a bank made below prime rate loans. We expect other juries to do likewise. Ultimately, what will happen is there will be significant savings in interest costs to the small business community and that should be a tremendous benefit for the whole country.

As circumstances would have it, I happen to be the individual who borrowed money from the First National Bank of Atlanta at the prime rate plus one, when, in fact, my bank was making loans below the prime. Prior to filing suit, but not prior to making my loans, I discovered that the banking industry was playing fast and loose with the prime rate and that there were loans below prime. This began to bother me because I thought I was a knowledgable individual. After all, I am a professor of business and law as well as a practicing attorney. I felt it was being ripped off and that agitated me enough to file a lawsuit on my own behalf. I felt that I had no choice. I felt that the only way a lawsuit attacking the prime rate would ever get filed was by me doing it. Since that time, I have been hired by others to file lawsuits on their behalf against banks, attacking their artificial prime rates.

These lawsuits against the banks are a statement to the banking community that the small business community resents being cheated and there are people who will do something about it. In fact, one of the Federal statutes being used by me in civil litigation on behalf of these business clients is the Racketeer Influenced and Corrupt Organizations Act.

Some banks have used the mails to commit fraud and I don't see why a bank should be immune from being accused of being a corrupt organization when it is engaged in racketeering practices. I know that bankers don't like being called racketeers. We normally think of racketeers as being people who benefit from narcotics, prostitution, and other similar types of illegal activities. However, this particular anti-racketeering statute is very broad and has been applied to businesses other than banking in the past. The time is now right to apply it to the banking industry.

Another possible solution is to have Truth-In-Prime-Rate law in addition to the courts commanding the banks to tell the truth. In any event, what we are saying is that the truth-in-prime rate should be made mandatory since the banking industry doesn't seem to want to do it on a voluntary basis. What may result is that the prime rate as we know it today will become an obsolete term.

Some bankers are saying that "we are above the law, we can charge any rate we want, we don't have to disclose how we compute the rate, and who cares about the small businesses, that's their problem." Often, when a bank announces that it is raising its prime rate, the reason given is "anticipation of additional Federal Reserve moves to fight inflation." One may wonder how effective high interest is as an inflation fighter. If one assumes that killing the patient is considered an effective treatment for illness, then high interest is an effective inflation tool. Of course, when the patient is only a small business person and not a banker, then why should the banking industry care?

One of the reasons given by the Federal Reserve for the raising of its discount rate and the reason then given by the banking industry for raising the prime rate is to discourage borrowing. That supposedly means that fewer people will end up borrowing money because it costs more and, consequently, we will have a slow-down in the economy. Then, ultimately inflation will some how disappear like a bad cold. What seems to be happening though is that this doesn't affect the borrowing by the largest companies at all, has been well documented.

There is an artificial prime rate to begin with. The smaller companies being wiped out are really the backbone of the economy. If you examine the statistics on employment, you will find that the majority of all jobs created in the United States during the past decade are jobs related to small businesses and not jobs related to giant corporations. High interest rates are putting those people out of work who can least afford to be unemployed.

It is a shame that we can't come to our senses and that may be because the banking industry provides so many of the advisors to the Federal Government. As long as the banking industry has such great influence over our Government, we are not going to get effective reforms. The banks contribute huge amounts of money to political campaigns through their political action committees. They use tremendous lobbying power for their own benefits. Only by small business being properly represented by this committee and similar committees in Congress will there be any favorable results for small business.

One may wonder why, when a large commercial bank announces its change in the prime rate, the members of the banking community all over the country snap too, fall in line and follow the leader. The banking industry will tell you that it is competition. That is, that the leaders are the largest banks on the East Coast, such as Citibank, Chase Manhattan and Morgan Guaranty, and on the West Coast, Bank of America and Security Pacific, and whatever these banks dictate, the other banks have to follow. I really don't believe that.

I don't think we'll find a "smoking gun", so to speak, where the big bankers get together at a meeting of the American Bankers Association or somewhere else and say, "why don't you raise the prime rate today, and by the way, when will it be my turn to raise the prime rate?" I believe that bankers are much more subtle than that. However, there is no doubt in my mind that what would be price rigging in another industry and what is prime rate rigging in the banking industry is a distinction without a difference. In other industries, their executives would be prosecuted, convicted, and hauled off to prison. Proving it in the banking industry . . . that's another story.

When a bank like the Stewardship Bank of Oregon announces that it is not going the follow the lead of the major banks, and it is going to make loans below the phony prime rate, that makes news. While I commend the Stewardship Bank because of its desire to provide a service to the small business community, the bank is certainly stepping out of line. It may have repercussions later on when that small bank attempts to borrow money from a larger bank. In fact, a reason why many smaller banks don't keep their best rate at a level below that of the so-called money center banks' prime rate is the same reason that a small business is reluctant to sue a bank. Fear!

The risks are great. After all, the bank can cut off your credit source. But I believe the fact that a small bank does not follow the lead of a money center bank highlights the fact that the true cost of money is considerably less than what the major banks tell us and, consequently, the major banks can afford to make loans to businesses at much less than the so-called prime rate. We know they do it anyway. Why not pass that on to small businesses? I don't see this as being anything other than preferential pricing.

Price discrimination against the small business community results from the prime rate being held out by the banking industry as its lowest rate when, if fact, the most credit-worthy corporate borrowers are told by their bankers that they can borrow money at significantly less than the prime rate. The artificiality of the prime rate is not revealed in advance to the small business person. When that person goes in to borrow money, he or she, is simply told how much it will cost. There is no bargaining power on the part of that individual. Consequently, when the bank puts down in writing that this is their best rate plus, "say, one point, two points, whatever it is", the individual has every reason to rely on the intergrity of the bank. I don't think that the typical business person would ever doubt a banker's word. After all, why would a banker lie? I know that's the way I felt until I discovered the truth for myself.

While the banking community states that it is simply a good business practice to try and strike a better deal with a larger customer than it is with a smaller customer or, in other words, to give the equivalent of a volume discount, that's not the issue. The issue is that stating something is best, that is, the "prime rate", which is the equivalent of lowest or minimum rate, and then giving a rate "better than best" to a preferred customer is a mockery of the rules of fair play. Unless the English language has changed a great deal since I went to school, there is not supposed to be anything better than best. Yet, the banks are really saying there is something better than best to the large borrowers who have tremendous bargaining power. The large borrower can say to the bank, "Wait a minute now. If you don't give me a rate below prime, I'm leaving. My corporation will sell commercial paper directly to the public." Now, what would your commercial paper or mine be worth sold directly to the public? Not much, I'm afraid.

The small business community is still being told that there is a best rate, that is, the "prime rate". My bank, the First National Bank of Atlanta, even went so far as to define "prime rate" in my loan contracts. Today, the banking community is getting more cautious and many banks are not spelling it out in the loan contract. Some are following the lead of Morgan Guaranty and are saying, in effect, "we are going to tell you what 'prime rate' means when we feel like telling you what it means, which is what we mean it to be and not what you know it to be." This is extremely deceptive. I can't imagine the automobile industry or the housing industry or any industry other than banking operating that way. They could not get away with it.

The posted prime rate has now become an excuse for banks to jack up interest rates. The banking industry has, in effect, stated that, "after all, we are the prophets of what interest rates will be and, consequently, we have to forecast what our costs will be; therefore, we are now going to set a rate." The irony of it is that this is a self-fulfilling prophecy. The banks set the rate and then they tell you that's the best rate.

The empirical data, gathered by the staff of the Committee on Banking, Finance and Urban Affairs of the United States House of Representatives, released on April 30, 1981, clearly shows that there is no such thing as a prime rate among the ten (10) largest banks in this country. The Committee staff recommends that the term, "prime rate", be discarded.

Even though the prime rate as we know it today is a rather empty term, when the prime rate changes, up or down, the stock market may react some fifteen (15) points in either direction. One may wonder how there can be such a reaction to the announcement of a new prime rate when that doesn't really mean anything any way. I don't believe that the stock market is a better barometer of what will happen in our economy than the prime rate is, but at least the stock market, as far as I know, isn't rigged. You have people buying and selling in a free auction market and we assume that the market is honest.

Recently, there has been so much publicity about the prime rate not meaning the best rate, but you can still read in a newspaper or listen to any newscast and the prime rate will be described as the best rate. Despite the adverse publicity regarding the meaning of the prime rate, the public is not yet ready to accept as a given truth that the banking industry is defrauding the small business community. Probably, the public doesn't want to believe that. I know that it took me quite a while to truly comprehend that I was being cheated by my own bank. The bankers know what they are doing even if some of us don't know what they are doing.

Is the prime rate simply a useful barometer of the direction of interest rates in general? The banking community would like the small business community to believe that it is, even though the prime rate no longer means the best rate. I, for one, do not believe the prime rate is an indicator of anything. The prime rate would only be an indicator if it were determined honestly.

The prime rate is no longer linked to money market rates. This has resulted in an unprecedented gap between the prime rate and money market rates. Money market rates are indicators for business interest rates. The money market rates are determined in the free auction market by buyers and sellers, whereas the prime rate is made by the bankers themselves. In others words, the bankers have been perpetrating a fraud on the American public by saying the prime rate is a barometer of anything. Do you still believe the bankers?

The prime rate today is not an accurate method for determining the cost of money to the small business community. While I have great faith in the free market system, I do not believe that the banking industry will voluntarily adopt a true benchmark for small business loans. The effect of allowing the banking industry to choose the prime rate as the benchmark to be used for small business loans is akin to turning the keys of an insane asylum over to the lunatics. Don't let the bankers make the rules for the small business community!

Mr. LAFALCE. Our next witness will be Mr. Paul Ruch, who is executive vice president and on the board of Marine Midland Bank, western region. He is also a personal friend of mine, who has expressed to me great concern as to what is the announced intention if we decrease the percentage of the guarantee, that is, if we reduce the guarantee from 90 percent to some lower percentage, such as 70 percent.

I asked Paul if he would be willing to come and testify primarily on that issue, and while it is not the primary issue that we are addressing, certainly it is interrelated and, therefore, I feel it is appropriate for today's discussion. Mr. Ruch.

TESTIMONY OF PAUL E. RUCH, EXECUTIVE VICE PRESIDENT, MARINE MIDLAND BANK, BUFFALO, N.Y.

Mr. RUCH. Thank you, Mr. Chairman, and gentlemen. If you will accept my previously submitted statement for the record, I can be brief and save 8 minutes for the next speaker.

Only highlighting the recommendations that were contained in my statement, we would ask your very serious consideration to a selective examination of the experience of SBA-identified bank lenders and of SBA regions and districts on a region-by-region and district-by-district basis to avoid a broadbrush solution to a problem that may very well be isolated. We are very concerned in this baby-with-the-bathwater idea that the small businessmen in the country as a whole will be severely damaged by a sharp and abrupt restriction in the amount of the guaranteed portions of the SBA participations.

The statistics are easy to dig out and should cause some thoughtful examination and some selective adjustment in standards and procedures in areas which are obviously far above the normal.

Our second suggestion is that the SBA consider limiting its activities to the guarantee function only, get out of the direct-lending business, which is a serious financial drain on the Agency, and I say get out of the direct lending business with the exception of disaster loans. All of the direct loans, it is my understanding, are made at a negative spread to the cost of funds to the SBA.

Our third recommendation was that the current total package of SBA programs be enhanced by the addition of the one package which is still missing, and that is the availability of a continuing guarantee, for instance, for a stated period of years with a maturity, on working capital requirements of small businessmen. This is a program that is not available at the moment. It is a program that is particularly appropriate as small businessmen in a highly leveraged position are expanding their sales but not expanding their bottom line because of conditions with which you are all familiar. We think that that working capital guarantee program should be a priority item for the SBA.

I can't leave this table, having heard all these remarks on the prime, without simply making the observation to you that if the banking system were in a surplus-funded position, if we had in fact the amount of core deposits that we need to sustain the lending activity, the key to the T-bill or some other instrument as an investment alternative option might be very appropriate. However, that is not the fact. The banking industry as a whole is incrementally funded, and by that I mean that we buy the money to support the loan activity to support the investments in hospitals, convention centers, civic service type opportunities. We are currently paying rates that are double digit, as is the inflation. We have seen advertised rates this week which purport to pay as much as 18 percent over a 7- to 8-year term. We have a cost of raising funds which is very substantial, and I think that the incremental nature of these funds must be considered when any type of benchmark is being approached.

Thank you very much.

Mr. LAFALCE. Thank you very much, Mr. Ruch.

[Mr. Ruch's prepared statement follows:]

PREPARED STATEMENT OF PAUL E. RUCH, EXECUTIVE VICE PRESIDENT, MARINE MIDLAND BANK, BUFFALO, N.Y.

Gentlemen: I am Paul E. Ruch of Buffalo, New York, Executive Vice President of Marine Midland Bank, N.A. Because of Marine Midland's heavy involvement with the Small Business Administration, we are particularly appreciative of the opportunity to address you this morning. To give you a reference point for my remarks, I would like to mention that Marine Midland is the second largest SBA lender in the nation; following only the Bank of America, and rapidly closing that gap. Our cooperation with the SBA programs covers a span of over 23 years and we have a keen interest in the future of the SBA and its programs. As one of the 20 lenders selected nationally to pilot the SBA Bank Certification Program, we hope that the inputs based on our experience with that program played a major part in its ultimate expansion to over 500 other participating banks.

Our specific concerns center around the rumored reduction of the maximum available guaranteed portion of Small Business loans from 90 percent to 75 percent. We see this proposal as having an ultimate detrimental impact on the aims of the program itself; in greatly restricting the availability of credit and, more importantly, in increasing the price of that credit to the ultimate user. It is no secret that the pricing of credit must reflect the three major components of raw cost of funds, operating expenses, and credit risk. If any of these variables is increased, the ultimate price escalates accordingly. We would suggest, gentlemen, with both rates and other costs at historic highs; that this is certainly not the time to further increase the cost of credit to the small businessman. Although the more responsible bank lenders have exercised restraint in not universally pricing their small business accommodations up to the maximums allowed by the program; any increase in the portions of the credit at risk are certain to force an escalation in the price of the total accommodation. In reviewing the 90 percent to 10 percent risk factors, it should also be noted that more often than not the SBA guaranteed loan is a part rather than the entirety of a customer's credit accommodation. With that in mind, you will appreciate that the bank's actual loss experience in situations where we are partnered with the SBA is far greater than the 10 percent which appears as the most visible number.

Gentlemen, we would recommend to you, in the strongest possible terms, the following points for your consideration. As an alternative to reducing the guarantee parameters across the board, we suggest that the experience ratios of all participating banks be examined and that those with sustained loss experience which greatly exceed the averages be focused on. The same type of statistical self-examination might be exercised on the specific districts and regions within the SBA to determine where excess losses have been incurred over a period of years. Approaching the problem in this fashion will avoid "throwing the baby out with the bath water" and will encourage the upgrading of standards and criteria which will result in improved experience.

Our second recommendation would be that the SBA discontinue its $239 million direct loan program, with the exception of disaster loans. The loans in question can, in our view, more properly be handled by the nation's participating commercial banks with a resultant decrease in funding requirements, operating expense, and negative interest spreads for the Small Business Administration.

On a more positive note, we would recommend for your consideration an improved working capital guarantee program to support the continuing working capital needs of small businesses which are both highly leveraged and rapidly expanding. This is the only apparent gap in the otherwise excellent package of products which the SBA offers.

The value of the current packages of SBA products to our national economy cannot be overstated. Businesses are started, jobs created, and foundations for growth are laid by entrepreneurs who would otherwise have no change of gaining self sufficiency, and the self respect which accompanies it.

Mr. **LAFALCE**. I am going to defer my questioning for the moment and give the other members of the subcommittee the first chance to question these witnesses. I will call on Congressman Roemer.

Mr. **ROEMER**. Thank you, Mr. Chairman.

I appreciate your testimony. It is very informative. I have a couple of questions for the gentleman from Kansas City. Is it Percy?

Mr. **PIERCY**. Piercy.

Mr. **Roemer**. You said something interesting. You said that you didn't think that the SBA participating loans needed to be guaranteed up to 90-percent, and that runs contrary, it seems to me, to other testimony from the same table. What is your reason for saying that, and do you disagree with the statements by some of the other gentlemen that we need to be careful in reducing that guaranteed portion?

Mr. **Piercy**. Well, I wouldn't argue about it. I am sure there will be more loans made at 90 percent, maybe, than there would be, or more easily made at 90 percent, than there would be at 75, but 90 percent guarantee kind of makes a small businessman feel like it is absolutely a court of last resort for money, No. 1.

No. 2, if you are familiar with what a small businessman has to do, how he has to secure himself with an SBA participating loan with the SBA and the bank, we have generally speaking—it is incredible some of the things that are brought out—but generally anything, any kind of an asset that you possibly have, almost coming up short of having your own children put in a lockbox, are guaranteed, and in my particular case, my wife guarantees and my brother guarantees and my brother's wife guarantees, and it goes right on down the line, and I just feel that with all of that kind of backup that it is a personal thing. That was the reason for it, the 90 percent.

Mr. **Roemer**. But you don't suggest—perhaps you do; I am phrasing it poorly—but do you suggest that if we back away from the 90 percent from those who qualified that interest rates would go down?

Mr. **Piercy**. No. No; I am not.

Mr. **Roemer**. OK. I don't remember how you said it, but you gave us the impression that you thought that most of these loans were high quality and low risk.

Mr. **Piercy**. That is right.

Mr. **Roemer**. I think that is exactly the phrase that you used.

Mr. **Piercy**. I think this banker from Kansas City, from United Missouri, indicated that. I think SBA statistics would indicate the quality of the loans if you look up the losses. My big argument with them, what we are talking about here, is that I can't see adding points. Now, I have debated this with bankers, too, and generally what I have told to me is that these loans are very difficult to do, the paperwork involved, and all of this. Well, I have done one myself—I have done more than one myself, and I have spent more time trying to sell a car of redwood lumber from Pacific Lumber Co., and the amount of paperwork and time that I have had to put in for a $600 commission one time than I had to work on an SBA loan, so that doesn't float with me.

Mr. **Roemer**. Let me hold you right there a second and ask the gentleman from United Missouri Bank, Mr. Bolt, if he agrees with that.

Would you agree with the statement that these loans are high quality, low risk, and if not artificially pegged over prime, could be discounted by the banking community in any way?

Mr. **Bolt**. I think you have to look at what the nature of your SBA loan is. First of all, it is typically a term loan running out anywhere from 5 to 10 years, supplying long-term capital needs. As the gentleman on my right here referred to it, the SBA program on working capital loans is not adequate to do the job. It just doesn't supply the needs that the business needs. So I would say on 90 percent of our SBA loans, we also have an unguaranteed portion, typically on accounts receivable, inventory, something like that, which I call a living loan, that goes up and down as the company goes forward.

So I think the 90 percent guarantee is important. The 90 percent guarantee gives it quality, not that the borrower isn't a quality borrower. Many times all of us start out with limited capital funds and things can happen to us, fires such as were expressed there. These businesses do not have alternate sources of funds. They do not have a big net worth behind them. The quality comes from the guarantee, and the desire and the selection on these loans adds a lot to the quality if you are working with people who are industrious, honest, and want to do things.

But very truthfully, we spend a lot of time with ours, and I think the most we give them, we give them something more than money, or try to, and that is, help them in their business, in their accounting. These people are not all experts in all fields, and we aren't either, but we can help them in these various areas. But they take more policing. They don't have the sophistication in some areas that many larger businesses have. I don't want to say they are poor quality, but as an investment-grade security, without the guarantee, it would not rank very high.

Mr. **Roemer**. But you, yourself, said in your statement, and I don't remember the exact figure used, but I thought it was a point and a half over your discounted prime, or call it real prime if you will, and that does not show anything but that small business loans, even in your bank, with your good reputation, are going to be charged at a premium rate rather than a prime or a large consumer or customer rate.

So the small businessman is at one heck of a disadvantage even at your bank.

Mr. **Bolt**. Now, wait a minute. When I said that, this is other small—let's say on accounts receivable. Are you familiar with accounts receivable lending?

Mr. **Roemer**. I have had a few; yes, sir.

Mr. **Bolt**. And the work that we get involved with, because we actually keep a duplicate set of books on what that customer has and it is a more expensive loan to administer.

Mr. **Roemer**. You are talking about factoring his accounts receivable?

Mr. **Bolt**. No; just loaning him on his accounts receivable. This is the best way we can work with him. We don't require minimum balances, we don't require compensating balances on that type of a loan. This happens to be a type of loan that allows a businessman to use his funds to the greatest degree and reduce his interest cost.

Mr. **LaFalce**. I am afraid the time of the gentleman has expired. We will have to go on.

Mr. **Roemer**. Thank you, Mr. Chairman.

Mr. **LaFalce**. Mr. Weber?

Mr. **Ed Weber**. Thank you, Mr. Chairman.

I was interested in what Mr. Kleiner had to say, especially about the use of the words "prime rate," that expression is another example of the way that we are eroding the meaning of words in the English language. I think that is really what you are saying in your testimony. How does the Wall Street Journal collect its data and decide what it is going to publish as its daily prime rate?

Mr. **Kleiner**. It gets that from the banking industry, sir. In other words, the prime rate is announced by your leading money center banks such as Citibank, on the east coast the Bank of America on the west coast, and then the Wall Street Journal merely publishes it. Of course, the Wall Street Journal defines it as the best rate given to the most credit worthy commercial borrower. That is the problem with it. The myth keeps marching on.

The English language may be eroding, but the small business person doesn't know that, even with this great publicity that we have today regarding phony prime rates. Every time there is an announcement of a major change in the prime rate, the stock market reacts, up or down. Now, we are supposedly dealing there with knowledgeable purchasers. I won't comment about that. The point is that the American public is not ready yet to accept the prime rate as a deceptive practice, not as a word, but as a fraud upon the public.

The prime rate, if it means what it says it means, would not be a problem. I have absolutely no qualms about the banking industry making profits. That isn't the case at all. It is, simply, should they call something the best rate when that business person relies on the integrity of the banker. After all, why would a banker lie? Most people trust their bankers. Even today, you go into a bank, you expect that the prime rate is the best rate, and it is further than just an erosion. I think it is fraud.

Mr. **Ed Weber**. How many lawsuits have you filed on this issue?

Mr. **Kleiner**. We have a half dozen right now, but frankly, we are looking forward to a bank-of-the-month club.

Mr. **Ed Weber**. Are these clients of yours, who have entered into loans, thinking that they were getting the prime rate and discovering that they were not getting the prime rate?

Mr. **Kleiner**. That is correct, sir.

Mr. **Ed Weber**. Have you had any lawsuits in which people have entered into loans in which the interest rate floats with the prime?

Mr. **Kleiner**. Every one of them, sir, are floating prime rate cases.

Mr. **Ed Weber**. I see what you mean. Have you had any courts that have ruled that this Racketeer Influenced and Corrupt Organizations Act is applicable to your case?

Mr. **Kleiner**. Not yet. We have a favorable decision based on plain, old, common law fraud, just garden-variety fraud. The Racketeer Influenced and Corrupt Organizations Act incorporates by reference mail fraud. We have some cases pending on that. I imagine that will go all the way up, possibly even to the U.S. Supreme Court. But we are taking a rather novel approach. I don't see any difference—that is just one man's opinion—between mail fraud perpetrated by the banking community and mail fraud perpetrated by the securities community. They go after many securities dealers on mail fraud. And we are not talking about a criminal charge on our part. It is a criminal statute, but it allows a civil remedy, very much like your antitrust statute.

Mr. **Ed Weber**. But no court cases have upheld that applicability?

Mr. **Kleiner**. Not to banks yet.

Mr. **Ed Weber**. And you are advocating a truth in prime rate law?

Mr. **Kleiner**. Well, I am advocating the truth. I don't know if we need a truth in prime rate law. I am not really one who thinks we need a great deal of regulation if there is honesty out there. There needs to be some way of enforcing the meaning of the term "prime rate" or let's do away with it. The green eyeshades have disappeared in banking. So can the prime rate.

Mr. **Ed Weber**. Thank you.

Mr. **LaFalce**. Mr. Dreier?

Mr. **Dreier**. Thank you very much, Mr. Chairman.

I think it would be appropriate for our subcommittee, since we have two witnesses from Kansas City, to express our condolences for the tremendous loss that they had in that terrible accident 2 weeks ago, and I just would like to state that. I say that specifically because my family still lives in Kansas City and it is my hometown. I would just like to state that for the record.

Also, I am feeling, certainly on the minority side, a tremendous sense of optimism over what occurred yesterday here in the Congress, and hope that we will be able to remedy some of the situation that Mr. Piercy was referring to with what we are designing as an attempt to stimulate the economy. Hopefully, there will be some provisions there that will provide some relief to some of the people working with you.

With respect to the basing of the guaranteed loan program, I am curious to know what recommendations any of you would have—and I am not directing this to any one individual—as far as an alternative to the prime. We have talked about T-bills, and I am curious to know about the discount rate, or the call money rate, or the Fed funds rate. What would be the best position right now that you all would recommend as far as basing the guaranteed loan program?

Mr. **Ruch**. I would suggest the 90-day CD rate.

Mr. **Piercy**. I would suggest the average rate in the district that the banks were loaning money at, what they call prime, to be the rate. There are like 10 districts, or 12, or whatever there are. Those figures are easily accessible from the Fed.

Mr. **Dreier**. I wonder how that would mesh with Mr. Ruch's testimony regarding standardization. You were concerned about throwing the baby out with the bath water, and I was wondering if a regional idea——

Mr. **Ruch**. That idea doesn't give me any problem at all, sir.

Mr. **Dreier**. Mr. Bolt?

Mr. **Bolt**. I think whatever base rate you choose, another thing that I think is very important, I think you must give a ceiling, and perhaps a floor. I think that the borrower needs a certain time limit in there where he isn't going to be going from 12 percent to 20 percent, for instance, in a 6-month period. I think the type of loans made under the SBA program, that those rates should stay in place, something similar to what you have been talking about on the variable-rate mortgage, where it can't move more than so much in a given 3-year period of time. That allows the businessman to plan for what his costs are going to be. I think that is most important.

I know we in our bank would have no objection if, let's say, you have a base rate and it could go up to 3 above that but not more than 3 above it, or 3 below it, as rates move. We would have no objection in our organization, as such, to putting a ceiling on it. As we mentioned here, we have rates right now on fixed rates from 7¼ on up on our current loans. But I do think it is important for the businessman in his planning. A base rate, I think we have to look at these things. They are not short-term loans. I have a problem on 90-day CD's. You would have to make such a markup over the 90 days.

Mr. DREIER. Because they are longer term?

Mr. BOLT. Right. Remember, right now 90-day CD's are out of proportion from where they usually are.

Mr. DREIER. Mr. Kleiner?

Mr. KLEINER. I would just briefly comment that I like the 26-week T-bill because it is widely accepted in the banking community and by the public at large. It is used right now for savings certificates by the banking community and thrift institutions.

Mr. DREIER. I would like to ask of Mr. Piercy, since he was really talking about the problems. I am just curious to know your reaction to what has occurred. I know this has been a pretty historic week here in Washington. Do you believe that what happened will have a salutary impact on the problems you are faced with?

Mr. PIERCY. I hope so.

Mr. DREIER. You hope so.

Mr. PIERCY. Let's put it that way. I think it has focused everybody's attention. I hope it has focused Congress' attention on just how bad the business climate really is, the free enterprise system and the grip that it is in. I would think that definitely there would have to be an improvement. But some of these things like this prime needs to be dealt with.

One thing I would like to make a comment on, on the prime rate, the whole situation with the prime rate is one of just if the business community understands really what it is, then I say buyer beware, but my complaint comes along the lines that most small business people do not know. Most small business people believe the prime rate to be the best rate that the bank loans its most credit worthy, and generally when you are talking to a small businessman, he says, "Well, I borrowed at 2 percent over what General Motors borrows for," and this is the concept that I have problems with, and I battle and I fight whenever I see any newspaper people write their traditional explanation of prime.

I have one here I want to read you. I have seen it rated one place, and if this would be published this way, in the Wall Street Journal on a regular basis, connected with the prime, then we could probably solve it all, and this comes from an Associated Press article, and it is the only time I have seen it.

> The prime rate is considered a bank's base lending rate on which it computes various types of loan interest rates for its different categories of customers. Some

short-term loans to blue-chip corporate customers are made below the prime rate while other customers, mainly small businesses, are generally charged more.

Now, if that is put across in a way that people can understand it, then I have no quibble with the prime rate anymore.

Mr. LAFALCE. The time of the gentleman has expired.

Mr. DREIER. Thank you, Mr. Chairman.

Mr. LAFALCE. I have a few questions

We have a number of different issues here that I would like to separate and discuss, but first, remember that we are here not because we are members of the Banking Committee, but because we are the Small Business General Oversight Subcommittee and the SBA has imposed a ceiling. But as that ceiling has been tied to the prime, we will discuss both issues.

Let's discuss the issue of ceilings per se. In some ways, ceilings are analogous to usury laws, which in some States are very restrictive. This was the case in New York State until November 1980. Missouri, I believe, still has a usury law that is restrictive under today's current conditions, at least in some respects.

I have introduced legislation that would federally preempt State usury laws on consumer loans. We have so many other types of preemptions now, business and agricultural, residential, et cetera, but in developing that law I attempted to not just have a total preemption, but to really set a Federal usury which would be reasonable. My problem was in trying to find an appropriate benchmark for that Federal ceiling. That was difficulty No. 1.

Difficulty No. 2 was in making that ceiling over an appropriate benchmark, in placing it so that it wouldn't be so high as to be laughed at and wouldn't be so low that rather than become the ceiling it would, in fact, become the standard for what could be charged above that benchmark.

I am wondering if that isn't a problem with what SBA has done over the years. Forget for a second, whether it is the prime or whether it is 90-day CD rate, or something else. If we establish the rate at 2¾ percent or so above that, is that not almost an invitation for the banking communities to charge precisely that, to go automatically to the ceiling?

What is your judgment, gentlemen?

Mr. RUCH. It could be construed that way. I don't see why any ceiling is appropriate personally. Let the free market force take over.

Mr. LAFALCE. Mr. Kleiner?

Mr. KLEINER. I have a problem with the free market in that it has to be a true free market, and that is part of my complaint. I don't think the banking industry is following that in the prime rate. I don't know if they would follow it in a CD rate or any other rate.

I don't like the idea of anything over whatever you use as an indicator or benchmark because I agree with the chairman that that would be an invitation to the banking community to just charge the highest rate. I think if you trace the history of these SBA-guaranteed loans, you will see they were fixed rates at one time and that should be the goal that we are headed toward so that the small business community can plan and budget just the way large corporations plan and budget.

Mr. LaFalce. I think it was your testimony, Mr. Bolt, that said that about 75 percent of your SBA loans were at fixed rates. Of course, if you look at the portfolio of most financial institutions, a great many of them would have the bulk of their business in fixed rates, but that is from a time when we had great regulation within the banking industry.

I am wondering, within the past year, what percentage of your SBA guaranteed loans have been at a fixed rate as opposed to a floating rate, given the past year's volatility and the probable future volatility of our economic markets.

Mr. Bolt. I would say in the last year—in fact, I have figures on it—I think about 80 percent are floating rates.

Mr. LaFalce. Right; so you have reversed it.

Mr. Bolt. But we have many times given the customer the choice.

Mr. LaFalce. Well, the choice when you are at a 20-percent——

Mr. Bolt. No; the choice is either floating or fixed.

Mr. LaFalce. Yes, I know, but when you are at 20 percent, you figure your chances are a lot more likely that they are going to go down, and you probably would have liked it fixed at 20 or 21.

Mr. Bolt. Well, I told you our highest one was 18½.

Mr. LaFalce. OK.

Mr. Bolt. I want to respond to this other. Of the loans we have that are floating with prime, only one of our loans is at the maximum rate allowed by the SBA and it has a ceiling of 21.

Mr. LaFalce. Let me get to another issue now. Mr. Ruch, you believe there is a strong case to keep the rate at 90 percent as opposed to lowering that reduction. Now, let's forget about this 2¾ percent. I haven't thought it through, but my initial inclination is that maybe we ought to just eliminate that 2¾ percent markup which we now permit.

An individual comes into your bank and he says, "I have been talking with my friendly adviser at the SBA and I think that if you work together with me and the SBA, I can get SBA to guarantee this loan at 90 percent." Ought that not to be an incentive to give him a lower interest rate than that which you usually give to your best customers, because your best customers are not fully guaranteed and they don't have a 90-percent guarantee by the Federal Government? First, they are putting your potential risk down to 10 percent. Second, that 10 percent is probably unbelievably collateralized. And third, you can also sell the guaranteed portion and have that money which you loaned in the first place to reloan again.

So would that not permit you to give that small businessman who is able to get an SBA guarantee a lower rate rather than charge on the 2¾, even though there is, I think, a very slight additional cost which might come about in working with SBA in the financing of the loan?

Mr. Ruch. Mr. LaFalce, forgetting for a moment the additional work involved, which is enormous, the 10 percent left at risk represents a far larger exposure to the bank than the amount at risk on a comparable credit.

Mr. LaFalce. Well, don't you have first call on that?

Mr. Ruch. No, sir, we share.

Mr. **LaFalce**. You share in that 10 percent with SBA?

Mr. **Ruch**. Right, as our interests appear. We took a look at the largest of our SBA——

Mr. **LaFalce**. Isn't that 10 percent almost always collateralized?

Mr. **Ruch**. The entire loan is collateralized by all of the available collateral, which more times than not does not approach the amount of the loan.

Mr. **LaFalce**. Don't you have first call on the collateral, rather than SBA?

Mr. **Ruch**. No; we do not.

Mr. **LaFalce**. That is shared also?

Mr. **Ruch**. We took a look at the records of our largest SBA lending unit over the past 4 years and despite the 90–10 percent relationship, we lost $27 for every $100 that the SBA lost on the credits that did not work out. I think that refutes the risk factor.

Mr. **LaFalce**. Mr. Bolt, do you have any data which would indicate what your loss would be on SBA guaranteed loans as opposed to your loss on nonguaranteed loans? How would they compare?

Mr. **Ruch**. Mr. Bolt may want to add to this, but I am told that the national loss experience on SBA loans runs in the vicinity of 4 percent. The target for the banking industry on conventional commercial lending is in the area of one-half of 1 percent.

Mr. **Bolt**. I agree. Your losses are going to run higher.

Mr. **LaFalce**. Well, how does that add up? We are meshing everything, including your big corporate clients in there, it would seem to me. Do you have any breakdown of just your small business community?

Mr. **Ruch**. I don't have a statistical breakdown, Congressman, but I can tell you that the lending that we do to small business, which is a large part of our operation, is that lending which requires the greatest work, entails the greatest risk, and has a larger loss experience than our other commercial loans.

Mr. **LaFalce**. I can appreciate that, but you have given me an overall loss experience in comparison to a loss experience with SBA guaranteed loans. Can you give me an overall loss experience with small businesses that are not guaranteed by SBA in comparison with your loss experience with SBA guaranteed loans?

Mr. **Ruch**. At this time I do not have that information. I will see if it is available.

Mr. **LaFalce**. I don't want to put you or Mr. Bolt through a lot of work, but I would like to know if that information is readily available, because I don't think you would have the spread that you have talked about—was it one half of 1 percent as opposed to 4—if you were comparing apples and apples, small businesses with and small businesses without. I don't know.

Mr. **Ruch**. Then we get into the question of who pays which rate as well. The loans with the lowest loss experience are entitled to the best rate. The ones with somewhat greater loss experience, a higher rate.

Mr. **LaFalce**. Are you saying that you believe there has to be some type of premium above whatever the best rate could be?

Mr. **Ruch**. Yes, sir.

Mr. **Bolt**. Yes. If you are going to have competent people serving them, you have to have it. We try to have very competent loan officers dealing with our small business people, customers, and we have to pay them, we have to be competitive. And yet they will spend five times as much time with a small businessman as they will with a large customer.

Mr. LAFALCE. Mr. Piercy made a point that he has a floating SBA rate that is adjusted every 6 months. Couldn't we have a policy that would only adjust up every 6 months, but that might adjust downward more frequently?

Mr. RUCH. To be fair, it should go in either direction with the same rapidity. It is only reflective of averages.

Mr. LAFALCE. I realize that, but in this past year, say, we have been averaging 20 percent, and the Reagan administration has predicted that starting October 1 interest rates on our 3-month Treasury bills will be 8.9 percent. At least that is the premise of their budget. If you accept the premise of the Reagan administration, shouldn't we have some way of reducing that a bit more rapidly?

Mr. RUCH. What about monthly recalculation in either direction?

Mr. PIERCY. That would be better.

Mr. RUCH. That certainly causes us no problem, sir.

Mr. LAFALCE. So you don't have any difficulty with the number of times we could recalculate; it is just that you would, of course, insist that it be, of course, equal up and equal down.

Mr. RUCH. Right.

Mr. LAFALCE. Is that the way it is now for adjustable-rate mortgages? Don't they go down more rapidly, and don't they permit you to adjust down more rapidly than up?

Mr. RUCH. I don't have any, but I can tell you that that is the way it is on many other commercial loans that are tied to the prime rate.

Mr. LAFALCE. What is that?

Mr. RUCH. Monthly adjustments.

Mr. LAFALCE. Monthly, either way; up or down?

Mr. RUCH. Right.

Mr. LAFALCE. Mr. Kleiner, explain to me the elements of fraud, at least in the State of Kentucky where you have the lawsuit, and tell me how those legal elements were found factually by the jury in your case.

Mr. KLEINER. Certainly. You have a representation of a material fact which is knowingly false, and you have a reliance on that representation of a false material fact to the detriment or loss of the individual or business.

Let me make a comment now, because I think I may have not understood the first question regarding the Racketeer Influenced and Corrupt Organizations Act. That particular statute, on mail fraud, has been successfully applied to other businesses, not to banking yet, but I want to make it very clear that this is not a way-out, crazy theory. It has been applied to other businesses, and successfully, and upheld by our appellate courts in the United States in various circuits.

Mr. LAFALCE. Have you or members of your staff prepared a legal memo on this?

Mr. KLEINER. We have legal memos, and we would be very happy to provide the subcommittee with them.

Mr. **LaFalce**. I would appreciate that. Could you also give me a complaint that you think would be most representative of your concerns that I might include in the record?

Mr. **Kleiner**. We just happen to have one along with us and we would be very glad to make a copy available to you, sir.

Mr. **LaFalce**. Thank you.

[The information referred to above follows:]

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

JACKIE KLEINER, *
and All Other Persons *
So Situated, *
Plaintiffs, * CIVIL ACTION
-vs- * FILE NO. C80-921A
THE FIRST NATIONAL BANK *
OF ATLANTA, *
Defendant. *

MEMORANDUM IN SUPPORT OF PLAINTIFFS' MOTION TO ADD A COUNT TO THEIR COMPLAINT SEEKING CIVIL RECOVERY UNDER THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT [18 U.S.C. 1964]

PURSUANT to this Court's Order of December 10, 1980, a Specification of Facts follows:

A.

OBSTRUCTION OF CRIMINAL INVESTIGATIONS [18 U.S.C. 1510]

1.

That on or about May 28, 1980, the Plaintiff, hereafter "KLEINER", on his own behalf and on behalf of all others so situated, filed a major civil action in this Court against the First National Bank of Atlanta, hereafter "FNB", United States District Court, Northern District of Georgia, File No. C80-921A, hereafter the "PRIME RATE CASE".

2.

That the PRIME RATE CASE alleges, in part, that FNB fraudulently determined the calculation of both the prime rate of interest and the daily rate of interest on loans to KLEINER and all others similarly situated.

3.

That the PRIME RATE CASE has received widespread publicity throughout the United States, is a major civil action in which tens of millions of dollars are at stake, and will create a legal precedent of great importance.

4.

That said civil action arises out of loan transactions between KLEINER and FNB, but said civil action does not arise out of any loan transaction between KLEINER and Tharpe & Brooks Incorporated, hereafter "T&B", the mortgage banking subsidiary of First Atlanta Corporation, hereafter "FAC".

5.

That General Counsel for FNB, who is also General Counsel for FAC and T&B, was given a copy of the Complaint on May 29, 1980 and that on the very next day, May 30, 1980, FNB and FAC, by and through various of their senior officers, removed KLEINER's loan file from T&B, thereby commencing a carefully conceived conspiracy to obstruct justice and to impede the rights of KLEINER and the other members of the class who are entitled to damages against FNB in the PRIME RATE CASE

6.

That the overt acts of said conspiracy to obstruct justice include, inter alia, the following:

(a) Destruction of pertinent documents;
(b) Removal and secreting of pertinent documents;
(c) Preparation of "dummy" files;
(d) Non-disclosure of true and material information to the Federal Bureau of Investigation, hereafter "F.B.I."; and
(e) Forgery of a loan application.

7.

That during the Fall of 1980, FNB presented false and misleading evidence to the F.B.I. which caused the Grand Jury and the United States Attorney for the Northern District of Georgia to commence a criminal investigation of which KLEINER was the target, and is no longer the target.

8.

That the criminal investigation concerned accusations by FNB that KLEINER made false statements on loan applications, allegedly in violation of 18 U.S.C. 1014, a statute that requires a fraudulent act of commission capable of influencing a financial institution's decision to loan funds.

9.

That the sole motivation of FNB, in attempting this obstruction of the American judicial system and in perverting our system of criminal justice, was to chill KLEINER and other members of the class of the PRIME RATE CASE as follows:

(a) To prevent KLEINER from being allowed to serve as the representative of the class inasmuch as it is within the discretion of the trial judge in the PRIME RATE CASE to disqualify a plaintiff-representative based upon an indictment, even though an indictment is merely an accusation of the commission of a crime;
(b) To prevent other members of the class from coming forward to act as the class representative because of the fear of the same type of treatment given to KLEINER; and
(c) To prevent other members of the class from agreeing to participate in the class action because of the fear of recrimination by FNB.

10.

That, in the instant matter, FNB in concert with FAC violated 18 U.S.C. 1510, by willfully having misrepresented information to the F.B.I. relating to alleged violations by KLEINER of 18 U.S.C. 1014, thereby obstructing justice and causing harm to KLEINER and the other members of the class who are entitled to damages against FNB in the PRIME RATE CASE.

B.

MAIL FRAUD [18 U.S.C. 1341]

11.

That on or about May 28, 1980, KLEINER, on his behalf and on behalf of all others so situated, alleged in the Complaint, Count V, paragraphs 28, 29 and 30 that "First National has made loans to certain of its 'most credit-worthy customers' at rates less than its published 'prime rate'." and "First National has charged the Plaintiffs rates of interest in excess of the contract amount called for in the various notes" and "said over-charging by the First National was willful and consititutes a fraud,".

12.

That the prime rate charged by commercial banks to their "best Commercial borrowers" sets a floor interest rate for other loans to less qualified business borrowers.

13.

That as a result of the December 23, 1980 deposition of Thomas Ralph Agnew, the FNB loan officer who made the KLEINER loans involved in the PRIME RATE CASE, there is an admission by FNB of having made loans at less than its prime rate as follows:

"Did you have occasion to make loans at below the prime rate?" (T - 38, Lines 1 and 2)

"Yes." (T - 38, Line 3)

"Did you have occasion to make loans to corporations, loans of $100,000 or over at less than the prime rate?" (T - 39, Lines 1, 2 and 3)

"Yes." (T - 39, Line 4)

"Have you ever been involved in a loan, in your official capacity with First National Bank, given to an individual a loan over $100,000 or more below prime and for 90 days or less?" (T - 41, Lines 19, 20, 21 and 22)

"Yes." (T - 42, Line 2).

14.

That the provision in the $115,000 note of December 31, 1979, which states "Interest shall be computed on a 360-day year simple interest." has been violated as follows:

If you take the annual rate of interest and divide it by 360, which is what FNB does, and then multiply it by 365 days for the year, which is what FNB does, you will get a higher rate of interest than if you multiply it by 360, which is what the contract calls for; that is, 360/360 is correct and 365/360 is not correct. See American Timber & Trading Company v. First National Bank of Oregon, 511 F.2d 980 (9th Cir., 1973), footnote one.

15.

That on November 3, 1980, by certified mail, KLEINER informed FNB of his rescission of the $115,000 note of December 31, 1979 because of FNB's violations of the Truth-in-Lending Act and Regulation Z thereunder; on November 13, 1980, FNB accepted KLEINER's rescission; and on November 14, 1980, FNB gave a refund check to KLEINER for the entire interest paid by him on the $115,000 note.

16.

That FNB's conduct between November 13, 1980 and November 14, 1980 constitutes an admission by FNB of violations of the Truth-in-Lending Act and Regulation Z thereurder, namely, that FNB fraudulently determined the calculation of both the prime rate of interest and the daily rate of interest on the December 31, 1979 loan to KLEINER.

17.

That FNB uses the mail in its ordinary course of business to send loan statements to its loan customers, including KLEINER and members of his class, to collect debts where FNB has fraudulently determined the calculation of both the prime rate of interest and the daily rate of interest on its loan statements.

18.

That, in the instant matter, FNB violated 18 U.S.C. 1341, by having devised a scheme for obtaining money by means of false representations to its loan customers through the mail, thereby committing mail fraud and causing harm to KLEINER and the other members of the class who are entitled to damages against FNB in the PRIME RATE CASE.

C.

UNLAWFUL DEBT [18 U.S.C. 1961 (6)]

19.

That on or about May 28, 1980, KLEINER, on his own behalf and on behalf of all others so situated, alleged in the Complaint, Count I, paragraphs 11 and 12, that "rates shall be determined and controlled by the appropriate usury statutes of the state of Georgia" and "the amounts as interest charged by First National to the Plaintiffs was in excess of the statutory amount, thereby being usurious.

20.

That "Prime plus 1%" has no ascertainable meaning where FNB fraudulently determined the "best" rate of interest rather than following some specified standard.

21.

That the rate of interest collected on the loans involved in the instant law suit exceeded, on many occasions, more than twice the enforceable rate of seven percent per annum, which is the statutory rate, according to Ga. Code Ann. §57-101.

22.

That, in the instant matter, FNB collected unlawful debts within the provisions of 18 U.S.C. 1961 (6) by being in the business of lending money where the usurious rate is at least twice the enforceable rate, thereby loan-sharking and causing harm to KLEINER and other members of the class who are entitled to damages against FNB in the PRIME RATE CASE.

D.

PROHIBITED ACTIVITIES

[18 U.S.C. 1962]

23.

That, in the instant matter, prohibited activities are covered by RICO as follows:

(a) Income derived by FNB is invested in interstate commerce.

(b) FAC has used the income derived by FNB to acquire subsidiaries such as T&B.

(c) T&B as the mortgage banking subsidiary of FAC participated in the conduct of FNB's affairs.

(d) FAC and T&B conspired with FNB in a pattern of racketeering activities and/or in the collection of unlawful debts.

Respectfully,

Joel Marc Merren

Jerome J. Froelich, Jr.

Bernard M. Gerber

The Plaza Towers
2575 Peachtree Road
Atlanta, Georgia 30305
(404) 262-1800

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served a copy of the within and foregoing pleading upon counsel for the opposing party by depositing a copy of same in the United States Mail with sufficient postage affixed thereon to assure delivery thereof to the following:

Richard M. Kirby, Esquire
Hansell, Post, Brandon & Dorsey
3300 First National Bank Tower
Atlanta, Georgia 30303

This the 16 day of January, 1981.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK
--------------------------------------x
BANCO DE VENEZUELA S.A., :
Plaintiff, :
-against- :
VANTAGE PETROLEUM CORP., :
Defendant. :
--------------------------------------x

BRIEF IN OPPOSITION TO PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

Introduction

According to Webster's New Collegiate Dictionary,

> "Prime Rate: An interest rate at which preferred customers can borrow from banks and which is the lowest commercial interest rate available at a particular time."

One understanding of the term, Prime Rate, is found in the Staff Report For The Committee On Banking, Finance And Urban Affairs, United States House of Representatives, 97th Congress, April, 1981:

> "For decades, the phrase 'Prime Rate' has been regarded as the very best interest rate available to the most credit worthy commercial customers of the nation's commercial banks."

Another understanding of the term, Prime Rate, is contained in a well-known business reporter published by Bank of America, the Small Business Reporter, Volume 14, No. 10:

> "The best barometer of interest rates on all short term borrowings is the Prime Rate, the lowest interest rate that an individual bank charges for short term loans to its biggest and most credit worthy customers."

Prime Rate - Breach of Contract

Plaintiff's Exhibit "A" attached to the Affidavit of Harry P. Barrand, Jr., in support of Plaintiff's Motion, is the Promissory Note of Vantage Petroleum Corp. dated September 2, 1980. Said Note refers to "the prime commercial lending rate of Citibank", which is the basis for calculating interest as agreed to by the parties.

Is there a "prime commercial lending rate of Citibank"? No, according to Hans H. Angermueller, Senior Executive Vice President, Citibank. See Citibank letter of March 12, 1981, attached hereto as Defendant's Exhibit "I".

Defendant's Affidavit in Opposition, sworn to by its Senior Vice President, Cheryl A. Iorizzo, page 13, paragraph 44, states:

"That Banco de Venezuela gave lower than prime rates to some of its other clients while charging defendant percentages over the 'prime rate'which rate was not the bank's 'lowest and best rate' and thus plaintiff was discriminating against Vantage Petroleum Corp. in both the original loans and in the bond and mortgage of which plaintiff contends defendants are guarantors."

From her Affidavit, it is clear that, based upon Defendant's understanding of the Promissory Note language, i.e., "the prime commercial lending rate", that Cheryl A. Iorizzo believed she was receiving "the bank's 'lowest and best rate', plus One Per Cent (1%)". What was Plaintiff's understanding of the term, Prime Rate?

A question of fact arises as to whether or not the minds of the parties did meet upon the terms of the contract, that is to say, that they did not both understand the term, Prime Rate, that one of them understood said term to be one thing and the other another thing.

Since the Promissory Note of September 2, 1980 refers to Citibank's "prime commercial lending rate" and Citibank does not have such a rate, according to Citibank, as per Defendant's Exhibit "I", then what does that phrase mean?

There is no definition of "prime commercial lending rate" in the contract, thus, creating a question of fact which may be resolved by the introduction of extrinsic evidence. Extrinsic evidence is admissable in order to prove the meaning of technical or trade terms (e.g., "prime rate"). 32A C.J.S. 962.

After the jury as the trier of the facts hears and sees the admissable extrinsic evidence, then the jury would be authorized to determine what exactly was the lowest commercial lending rate of Plaintiff Bank and Citibank in order to determine damages.

Prime Rate - Fraud

A significant issue in this case is whether or not the Plaintiff Bank represented to Defendant in the Promissory Note of September 2, 1980 that Defendant's loan was based on the lowest commercial lending rate of Citibank and not Citibank's "Base Rate" when in fact Plaintiff Bank made loans at below either its own "Prime Rate" or Citibank's "Base Rate" and Plaintiff Bank knew that the "Prime Rate" as used in connection with this Note was not the best rate, and that the Defendant, relying upon the truthfulness of Plaintiff Bank's written representations in the Note, executed the Note to its detriment.

The evidence will clearly show that Plaintiff Bank made below prime rate loans on a regular basis, both before and after the granting of the loan in this case. The course of conduct of Plaintiff Bank appears to be no more than garden variety fraud. Defendant's Affidavit in Opposition, cited above, states, "That Banco de Venezuela gave lower than prime rates to some of its other clients---".

This Affidavit shows, and the evidence to be adduced at trial will show, that the representations made by Plaintiff Bank to Defendant were knowingly false, and Defendant relied upon these false and fraudulent representations to its detriment. Thus, all the elements of actionable fraud are present in this case and it will be left for the jury to determine what damages Defendant may recover, which damages may greatly exceed any amount allegedly owed to Plaintiff Bank.

Respectfully submitted,

KLEINER & MERREN

By:____________________________
Jackie Kleiner,
Of Counsel for Defendant
Vantage Petroleum Corp.

2575 Peachtree Road
Atlanta, GA 30305
(404) 262-1800

CITIBANK

Hans H. Angermueller
Senior Executive
Vice President

RECEIVED
MAR 13 1981
Banking, Finance & Urban Affairs Committee

March 12, 1981

The Hon. Fernand J. St. Germain
Chairman
U.S. House of Representatives
Committee on Banking, Finance and Urban Affairs
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman St. Germain:

Mr. W. B. Wriston has asked me to respond to your letter to him of February 12, 1981 wherein, among other things, you express concern about "the widening credibility gap between...commercial banks' prime lending rates and actual day-to-day lending practices" and in which you appear to conclude that the banking industry has been misleading the public and thereby contributing to the inflationary high interest psychology of the nation.

We at Citibank respectfully disagree with this conclusion. Citibank's "Base Rate" (not, incidentally, "prime rate"), which we announce as prevailing from time to time, is determined periodically by an Asset and Liability Committee composed of senior officers of the bank on the basis of rates currently and recently in effect with regard to actively traded independent money market instruments. The Base Rate is reviewed at least weekly by this Committee to determine its continued applicability. I can assure you that the Base Rate is an important element of our lending practice and extreme care is used in establishing its level. As you suggest in your letter, a very significant portion of our domestic commercial and industrial loan contracts are tied to our Base Rate.

Nevertheless, for several years there have existed lending rates for certain specialized short term borrowings which at times may be below our Base Rate. For example, the brokers' loan rate, which involves the extension of secured credit overnight to creditworthy brokers has traditionally been below our Base Rate. Also, during the past few years short term borrowings (and long term borrowings with short term interest periods each with a different fixed rate) have, on occasion, been offered at rates based on the London Interbank Offered Rate (LIBO) as well as on matched rates based on the domestic cost of funds. Rates based on LIBO or on the domestic cost of funds include a margin over the respective rates on which they are based and may include an adjustment to compensate for reserve and FDIC insurance requirements. In periods of normal money market conditions, there should not be a significant difference between the rates based on LIBO or on the domestic cost of funds and the Base Rate for the same maturity periods. However, at certain phases in an interest rate cycle, one rate could lag the others.

In essence, these specialized short term rates are intended as a competitive response to foreign bank lending (almost all of which is LIBO based) which is not affected by the domestic requirement to maintain reserves and FDIC insurance, as well as a response to domestic open market paper where, again, no reserves and FDIC insurance are required. Foreign banks make more than 10% of the commercial loans in the United States, and their competitive impact cannot be ignored. Similarly, at year-end, the amount of open market paper outstanding was twice as much as the total amount of all domestic commercial and industrial loans made by the large weekly-reporting commercial banks in New York City and Chicago.

The following are the answers to the specific questions enclosed with your letter.

1. As indicated above, Citibank does not use the term "prime rate". Instead, we refer to our "Base Rate", which is defined in our loan documentation as follows:

   > "The rate of interest announced publicly by Citibank, N.A. in New York, N.Y., from time to time as Citibank's base rate."

   You will note that the foregoing definition is not the definition of "prime rate" which is quoted in your letter.

   The Base Rate is publicly announced within minutes of its determination by the Asset and Liability Committee.

2. As indicated above, the Base Rate is reviewed weekly by the Asset and Liability Committee, and more frequently if market conditions dictate.

3. Citibank does not give loan customers discounts from the Base Rate. As indicated above, there are specialized short term loans and those rates may, at times, be below our Base Rate.

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4. We have made a sample of all domestic commercial and industrial loans outstanding as of May 30, 1980 and January 31, 1981 which were booked in Citibank's North American Banking Group which lends to large domestic corporate customers. The weighted average rate on these loans on May 30, 1980 was 14.76% as compared to our Base Rate on that date of 14%. On January 31, 1981, the rate was 19.73% as compared to our Base Rate of 19.5%.

5. The Base Rate and the other rates on which our loans are priced are widely known and publicly available.

6. Citibank does have domestic commercial and industrial loans on which the interest rate floats with the Base Rate or other rates agreed upon in advance. These loans currently make up approximately three-fourths of the dollar volume of the North American Banking Group's commercial and industrial loan portfolio.

We have prepared our response to question 4 on the basis of records reasonably available and for this reason the answer is not in the format requested. To submit information in precisely the detail requested would have been extremely burdensome within the time frame available.

Very truly yours,

Hans H. Angermueller
Senior Executive
Vice President

CEIVED
GRIDER, CLERK
JUN 2
U. S. DISTRICT COURT
WEST'N DIST. KENTUCKY

THE UNITED STATES DISTRICT COURT
THE WESTERN DISTRICT OF KENTUCKY

JOE PAT DOWNS, and §
BARDSTOWN SHOPPING CENTER, INC., §
Plaintiffs §
vs. § CIVIL ACTION
UNITED KENTUCKY BANK and § FILE NO. C81-0366L (B)
UNITED KENTUCKY, INC., §
Defendants §

COMPLAINT

COME NOW the Plaintiffs, by and through their attorneys, and show as their Complaint against the Defendants as follows:

JURISDICTION AND PARTIES

1.

That jurisdiction in this action is based upon the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1964.

2.

That the Plaintiffs above named are

(a) Joe Pat Downs [DOWNS], a resident of Bardstown, Kentucky, and the President of Bardstown Shopping Center, Inc., who is the guarantor of certain notes described hereinbelow;

(b) Bardstown Shopping Center, Inc. [BSCI], a Kentucky Corporation having its principal place of business in Bardstown, Kentucky, and in the business of operating a shopping center in Bardstown known as Bardstown Shopping Center.

3.

That the Defendants above named are

(a) United Kentucky Bank [UKB], a national bank with its principal place of business in Louisville, Kentucky;

(b) United Kentucky, Inc. [UNITED KENTUCKY], a bank holding company which owns UKB and has its principal place of business in Louisville, Kentucky.

CAUSE OF ACTION

4.

That, Defendants, UKB and UNITED KENTUCKY, operating together, are an enterprise as defined in 18 U.S.C. §1961(4).

5.

That the activities of Defendants with respect to the Plaintiffs were perpetrated over a substantial period of time, thereby, constituting a "pattern" of activity unlawful under 18 U.S.C. §1961(5).

6.

That Defendant, UKB, conducts the activities of the enterprise through a pattern of racketeering activity, with the activities of the Defendants' enterprise affecting interstate commerce and the enterprise engaged in interstate commerce, being prohibited by 18 U.S.C. §1962(c).

7.

That on April 10, 1979, Plaintiff, BSCI, through its president, Plaintiff, DOWNS, entered into two Kentucky contracts [NOTES] with Defendant, UKB, whereby UKB agreed to loan BSCI the sums of Seven Hundred and Thirty Thousand ($730,000) Dollars, and Five Hundred and Seventy Five Thousand ($575,000) Dollars for the purpose of constructing a shopping center in Bardstown, Kentucky; said NOTES are marked as Exhibits "I" and "II" and attached hereto.

8.

That the NOTE for Seven Hundred and Thirty Thousand ($730,000) Dollars, Exhibit "I", called for BSCI to pay interest monthly "at a rate equal to two (2%) "percent per annum" over the prime rate in effect for large commercial borrowers".

9.

That the NOTE for Five Hundred and Seventy Five Thousand ($575,000) Dollars, Exhibit "II", called for BSCI to pay interest monthly "at a rate equal to two and one-half (2½%) "percent per annum" over the prime rate in effect for large commercial borrowers".

10.

That Plaintiff, DOWNS, was the personal guarantor on both NOTES.

11.

That from, on or about April 10, 1979, the Defendants led the Plaintiffs to falsely believe and, to falsely rely on to their detriment, that UKB's "prime rate" was its best rate, when in fact, and the Defendants well knew, that the rate they were charging Plaintiff, BSCI, was not Defendant's, UKB, best rate.

12.

That Defendant, UKB, began communicating on a monthly basis with Plaintiff, BSCI, by mail, from approximately May 1, 1979 and continuing to the present day, as part of a scheme to defraud Plaintiffs through willfully overcharging the interest on false loan statements.

13.

That these loan statements were false in that Defendant, UKB, fraudulently determined both the calculation of its prime rate and the daily rate of interest on the Plaintiff's, BSCI, loan statements.

14.

That Defendants monthly use of the United States mail was part of its scheme to defraud the Plaintiffs and was in violation of 18 U.S.C. §1341 and 18 U.S.C. §1961 et seq.

15.

That as a direct and proximate cause of the foregoing unlawful acts of Defendants, Plantiffs have sustained damages in an amount estimated to be approximately Two Hundred Thousand ($200,000.00) Dollars, which Plaintiffs request be trebled pursuant to the provisions of 18 U.S.C. §1964(c).

WHEREFORE, Plaintiff's respectfully request trial by jury on all issues subject to such trial and that they be granted the following relief:

Mr. **LaFalce**. As I understand the comments of the two bankers present, it seems to me that although they might not share in all the concerns that have been expressed regarding the prime, they might agree that the prime is perhaps not the best benchmark to be used by the SBA. They might disagree as to what is the best, but they would share their qualms about the prime.

Is that a fair assessment of your feelings, Mr. Ruch?

Mr. **Ruch**. I don't have an argument on the prime, but I would think it makes sense.

Mr. **LaFalce**. All right. Now, you want something that is going to reflect the raw cost of funds, operating expenses, and credit risk; at least that is what your charge would be. What is the raw cost of funds? What is the benchmark for that?

Mr. **Ruch**. It is a difficult number to separate, sir, and trying to come up with a guesstimate on it, I note that in our published figures, our operating expenses equal 23 percent of our interest expenses. Now, you could say yes, but your operating expenses include lending, and coming to Washington, and other things.

Mr. **LaFalce**. Does ABA have a breakdown of what the average operating expense is for a bank as a percentage of interest expense?

Mr. **Ruch**. Yes; but it wouldn't be reflective only of the cost of raising money. It would also reflect the cost of lending money and doing the other things that the bank does.

Mr. **LaFalce**. I am still having difficulty with the raw cost of funds and how that is determined. I don't have that set in my mind very well. Mr. Bolt, could you comment?

Mr. **Bolt**. I think it will vary from bank to bank depending upon their deposit mix. You have characteristics—let's take a bank located in a German community. They are typically bigger savers and believe more in passbook savings, which is right now a low interest cost. You can go to another location and you find that they are after the highest rate on everything and that five of them will band together and come up with $10,000 and the money market rates.

So it will vary. It depends on the area you are serving. So it is hard to put all banks in one category on their cost of funds. You can't do it.

Mr. **LaFalce**. Let's talk about the value and the articulation of the prime. Doesn't it do more harm than good? The prime is not really something that is based upon the market, it seems to me. You have one bank—most often a New York City bank—or it could be Chicago, or maybe Houston, and they increase it by one-half of 1 percent and then almost automatically, within a day or two, almost all the other banks follow suit.

I hesitate to use the term "price fixing" because that has a legal connotation, which I want to stay away from, yet it appears that price fixing is taking place because of the herd reaction that seems to be taking place. What would happen if banks didn't publish so-called prime rates; if they just conducted their business without publishing these rates? Could banks operate in this fashion? What would happen if suddenly banks and the Wall Street Journal didn't publish it? Would this change the banks' operations all that much?

Mr. **Ruch**. I think it would create a great deal of confusion, but in answer to the first part of your question, Congressman, if half the banks in the country chose to go up on the prime and the other half remained substantially under it, they would be at a competitive advantage if your theory were true. All the loans would shift to the banks with the lower prime, so it would be to their competitive advantage if economically they could stay under the national prime figures.

Mr. **LaFalce**. Assuming those banks that established the prime were in fact charging the prime.

Mr. **Ruch**. Right.

Mr. **LaFalce**. But if the banks establishing the prime were not in fact charging it, do we have any data as to the number of loans given at any point in time that charged prime, prime-plus, prime-minus?

Mr. **Bolt**. For the industry?

Mr. **LaFalce**. For the industry or for individual banks.

Mr. **Bolt**. We have that all the time.

Mr. **LaFalce**. You have that all the time?

You were saying that all your loans as of a certain period in time were charged at the prime, and you didn't deviate, at least from March or April of 1980 on? May I ask what percentage of your loans that was at that time?

Mr. **Bolt**. Yes; we operate primarily on 90-day notes. So with the moving of rates, we can have loans on the books that are below prime at the time, but when they come up for renewal, they will become prime because of the movement of prime in the meantime.

Mr. **LaFalce**. Mr. Bolt, let's go prior to April 1980, if you will.

Mr. **Bolt**. We didn't break it then, either.

Mr. **LaFalce**. You didn't break it down, so you wouldn't have it.

Mr. **Bolt**. We had the breakdown, but we did not loan below prime.

Mr. **LaFalce**. I see. Even before April 1980.

Mr. **Bolt**. There was something passed by Congress called FIRA, the Financial Institution Regulatory Act. Typically in our part of the country, where we have a lot of correspondent banks and many unit banks and over the years we have financed many of these people to buy those banks, it was sort of traditional that they paid a half under the prime rate. When FIRA came in, we eliminated that. We could not give preferential because they controlled bank balances which were——

Mr. **LaFalce**. Is that right? Was it the general standard for banks not to give interest rates below the published prime subsequent to the passage of FIRA, or is your bank unique?

Mr. **Bolt**. Maybe our bank is unique. I can't speak for other banks.

Mr. **LaFalce**. Mr. Kleiner, do you have any comment that you would like to make, and have you used FIRA in your complaints?

Mr. **Kleiner**. Not yet, and I am glad that you have called it to our attention, though.

One of the things that very often is quoted in the Federal Reserve quarterly survey, which I believe the gentleman is referring to, and the information in that survey is quite extensive, it is for 48 sample banks that are used, and the Federal Reserve does show what a high percentage of below-prime rates are being made. I think that is very significant.

As far as any Federal statute being violated by making the low prime rate——

Mr. **LaFalce**. What Federal Reserve study are you referring to?

Mr. **Kleiner**. It is a quarterly study that comes out every quarter. I think the bankers could give the title. They are in a better position to identify it, but it comes out every quarter from the Federal Reserve and it covers the 48 sample banks that are used. I don't know which 48 are in that yet. We hope to get that information from the Federal Reserve.

Mr. **LaFalce**. Well, aside from which 48 banks are in the sample, do you have a copy of their study that you have used as part of——

Mr. **Kleiner**. Yes; we have a copy of the study.

Mr. **LaFalce**. Could you submit a copy for inclusion in the record?

Mr. **Kleiner**. Yes; we have that with us and we would be glad to.

[The information referred to above follows:]

July, 1980

Short-term Business Lending at Rates Below the Prime Rate*

I. Introduction and Summary

The cost of business credit, and interest rates generally, increased throughout most of the period from 1977 through 1979 and continued to rise until the spring of 1980, reflecting the underlying strength of demands for funds, boosted by accelerating inflation, and the efforts of the Federal Reserve to restrain monetary growth. As is illustrated in chart 1, however, quarterly survey data indicate that the average rate on new short-term business loans has increased less than the prime rate since early 1977, while the prime rate itself—with the exception of the second quarter of 1980—generally has stayed about 3/4 to 1-1/4 percentage points above the commercial paper rate.[1] In part, the relatively slower rise in the average cost of short-term bank business credit reflects a growing volume of short-term bank loans made at rates below the prime rate. Below prime lending initially became significant at money center banks, where the spread between the average rate on these loans and the prime rate averaged

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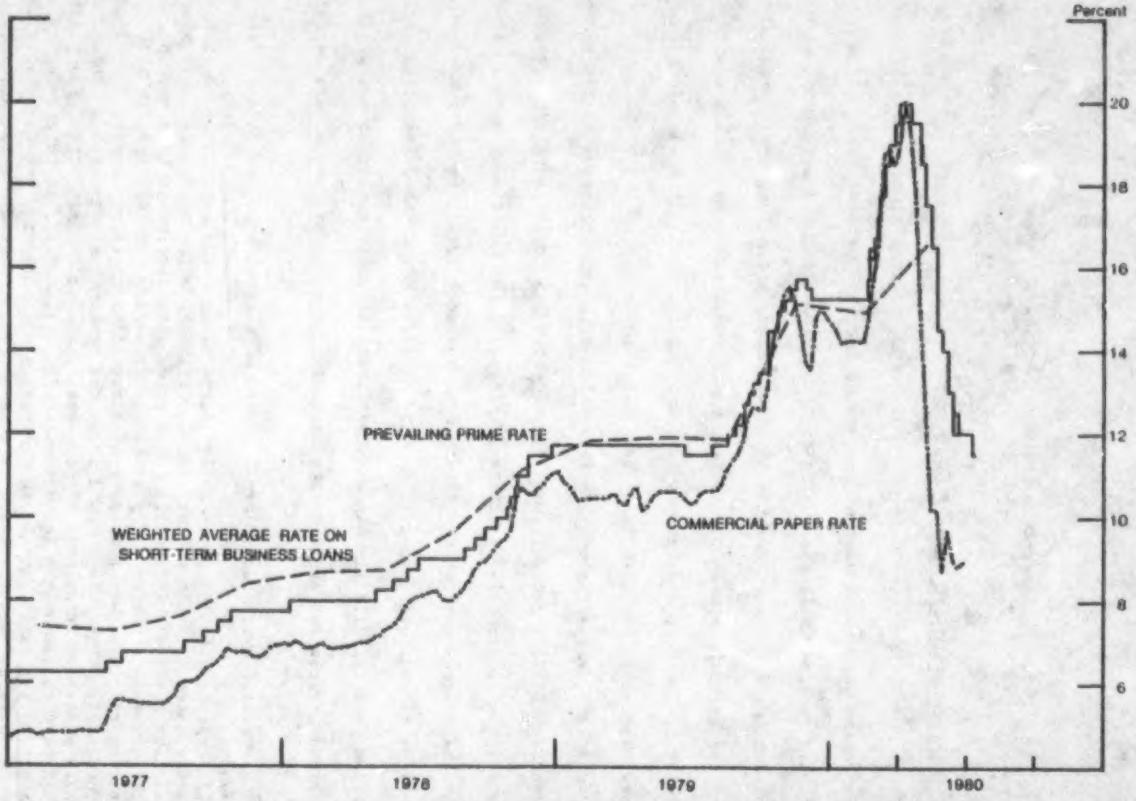
* Prepared by the staff ~~of the Board~~ of Governors of the Federal Reserve System.

[1] Beginning in the early 1970s, large banks began explicitly to link their prime rates to money market rates. Citibank, which introduced this practice, employs a formula that calls for a prime rate determined by a markup over a three week average of money market rates. From mid-1973 through 1978 the money market rate used was a measure of alternative costs of credit, the 90-day commercial paper rate. Since 1979, the markup has been over a measure of the bank's cost of funds, the 90-day certificate of deposit rate. The practice has been to review the formula weekly and, generally, to adhere to it. As money market rates plunged in the spring of this year, however, banks abandoned such formulas, and the prime rate recently has declined comparatively slowly. As a result, an unprecedented gap has opened between the prime rate and money market rates.

Chart 1

Selected Measures of the Cost of Short-term Credit



between about one-half and one percentage point over the years 1977-1979. This spread widened in 1980 (see table 1). High percentages of short-term loan extensions at rates below prime also have developed at medium and smaller banks, generally at somewhat larger spreads below prime than at large banks.

Below prime lending at large money center banks mainly represents very large extensions of credit for very short periods at rates linked to money market rates.[1][2] At large non-money center banks and at medium sized and smaller banks, below prime lending appears primarily to reflect several other factors, including two-tier lending programs favoring small businesses (which may also explain some of the below prime lending at money center banks), the lesser reliance of many smaller banks on large denomination CDs and other relatively costly purchased funds, and the interaction of rising interest rates with the presence of cap provisions on the larger share of below prime loans extended under commitment at these banks.[3] Despite the growth of below prime lending and the relatively restrained increase in the overall cost of bank credit in recent years, the commercial bank share of outstanding short- and intermediate-term credit--comprising all business loans at commercial banks, commercial paper issued by nonfinancial businesses, business loans at finance companies, and bankers acceptances held outside banks--declined from 70 percent at the end of 1976 to 66-1/2 percent at the end of 1979.

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[1] Below prime lending also has been examined in "Changes in Bank Lending Practices, 1977-79," Federal Reserve Bulletin, October 1979, pp. 797-815, and in P. Boltz and T. Campbell, "Innovations in Bank Loan Contracting: Some Recent Evidence," Staff study, Board of Governors of the Federal Reserve System.

[2] Since the prime rate is a measure of the cost of short-term credit, this report focuses on the relation between the prime rate and rates on short-term (one-year-and-under) bank loans.

[3] Also included in loans made at rates below prime at all sizes of banks is an unknown, but probably quite small, volume of "restructured" loans that have been renewed at reduced rates in order to prevent default.

Table 1

Short-term Business Lending Below the Prevailing Prime Rate By Selected Classes of Banks 1/

Class of bank	Percent of Gross Loan Extensions Made at Rates Below Prime					Spread Between Prime Rate and Weighted Average Rate on Loans Made Below Prime (basis points)				
				1980^p					1980^p	
	1977	1978	1979	Feb.	May	1977	1978	1979	Feb.	May
48 Large	8.8	16.1	32.6	50.0	58.8	79	62	92	123	414
13 Money Center	12.2	17.5	38.3	55.2	67.5	77	67	84	116	431
Large Non-money Center	4.2	14.5	22.7	40.5	31.8	95	53	114	142	309
Large New York City	15.7	22.6	43.3	67.0	67.0	69	68	88	118	419
Large Non-NYC	3.5	11.1	22.0	31.5	51.7	111	57	97	134	410
Medium and Smaller	3.0	10.5	33.4	32.8 (15.2) 2/	43.3 (26.8) 2/	87	82	162	220 (211) 2/	245 (247) 2/

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p--preliminary

NOTE: Annual data are averages for the four survey weeks in each year.

1/ Short-term loans have a maturity of one year or less. The prevailing prime is that posted at a majority of 31 large banks.

2/ Calculated using actual prime rates posted by respondent banks on survey dates. This information became available beginning with the August 1979 survey. With the exception of May 1980, at 48 large banks actual primes do not differ from the prevailing prime. For calculations using actual May primes, see appendix table 1.

Survey data indicate that substantial volumes of gross loan extensions at rates below prime appeared earlier and have remained more important at large money center banks. However, the volume of below prime lending reported by money center banks is importantly influenced by the very short average maturity of these loans. When this factor is taken into account, there is nothing to suggest that the share of portfolios accounted for by loans made at rates below prime differs substantially between money center banks and other banks. Finally, an examination of average rates paid on loans of various sizes indicates that rates on small loans rose less than rates on large loans between early 1977 and early 1980. In fact, rates on small loans were actually below those on very large loans in late 1979 and early 1980. To the extent that size of borrower can be inferred from relative size of loan, these findings suggest that, in the recent environment of very rapid increases in nominal interest rates, the average cost of credit to smaller borrowers has at times been below the average cost to larger borrowers.

The survey data analyzed in this report provide information on several characteristics of loans made by respondent banks during the first full week of the middle month of each quarter. A sample of 340 banks—selected to represent all insured banks—reports the size of each loan (including renewals) made during this period, its term to maturity, its commitment status, the interest rate charged and whether the rate is fixed or floating. Beginning with the August 1979 survey, banks also report their prime rate in effect on the survey dates.1/ Reported interest rates on loans may be affected

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1/ Data are from the Survey of Terms of Bank Lending (STBL). Forty eight large banks report all loans made on certain specified days of the survey week, while other respondents report all loans made on all days of the survey week. The STBL is described in detail in the May 1977 Federal Reserve Bulletin, pp. 442-445.

by a variety of unmeasured factors--for example, the presence and size of compensating balances, the nature of the collateral if the loan is secured, and other dealings between the bank and the borrower, such as cash management services. Thus, survey rates may not accurately measure the overall cost of the credit extended. Nevertheless, the survey does provide a fairly comprehensive, regularly collected series on bank lending terms, and the general trends that it reveals appear to be broadly reflective of bank lending developments.

II. Below Prime Lending at 48 Large Banks[1/]

As shown in table 2, the volume of short-term business loans extended at rates below prime by 48 large banks, expressed as a percentage of their total short-term business loans extended, has been rising since 1977, roughly doubling in 1978, 1979, and 1980. Typically, loans made below prime by these banks are far larger than their loans made at or above prime--on the order of 5 to 10 times as large--and have considerably shorter maturities--well under a month, on average, compared to 2 to 2-1/2 months for other loans. These size and maturity characteristics of below prime loans at large banks primarily reflect lending activities at money center banks (compare tables 3 and 4.)

In most survey weeks, almost all below prime lending at money center banks has been done at rates above money market rates. Lending at rates tied to the money market had its genesis at agencies and branches of foreign banks, which began around 1977 to make credit available at a markup over the LIBOR rate. Below prime lending at large money center banks appears to be aimed at countering both this development and competitive inroads also being

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[1/] As of December 31, 1979, the average assets of the 48 large banks were $10-1/2 billion, and the smallest of these was $2 billion. For all insured banks on that date, assets averaged $97 million.

Table 2

Selected Characteristics of Gross
Short-term C&I Loans Extended by 48 Large Banks

	1977				1978				1979				1980^P	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
centage of gross loan ensions accounted for loans made at														
rates below prime	8.0	4.3	13.6	9.3	15.4	13.2	16.0	19.8	34.2	39.8	37.5	18.7	50.0	58.8
rates below money market rates 1/	7.9	.2	.7	.2	.4	.2	.1	3.7	2.8	1.8	.8	5.6	1.1	.7
rates below prime and not under commitment	6.6	2.6	10.6	5.6	8.1	7.6	8.6	10.6	20.8	23.5	24.8	12.6	27.6	24.9
rage maturity (months)														
Loans above prime	2.1	1.8	2.4	2.2	2.3	2.1	2.3	2.5	2.6	2.7	2.2	2.1	2.3	2.5
Loans below prime	.8	.7	1.5	1.0	.7	.4	.7	2.0	1.1	.7	.9	1.1	.5	.9
rage size ($1,000)														
Loans above prime	141	168	166	162	145	186	153	206	138	184	202	361	227	208
Loans below prime	2,385	1,724	1,958	731	1,229	1,445	421	343	534	994	1,011	237	1,115	1,233

-preliminary

TE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

Table 3

Selected Characteristics of Gross Short-term C&I Loans Extended by 13 Money Center Banks

	1977				1978				1979				1980p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
rcentage of gross loan tensions accounted for loans made at														
rates below prime	11.1	4.7	22.6	10.6	19.5	12.1	20.6	17.8	42.3	42.4	44.7	24.0	55.2	67.5
rates below money market rates 1/	1.6	.5	1.0	.1	.0	.0	.1	3.2	3.3	1.9	.8	7.1	.3	.5
rates below prime and not under commitment	11.1	4.7	17.7	6.8	11.1	8.5	12.9	8.1	30.1	29.5	31.6	17.5	33.5	29.8
,erage maturity (months)														
Loans above prime	2.3	1.9	2.0	1.9	2.4	2.0	2.2	2.3	2.7	2.7	1.9	1.7	2.4	2.4
Loans below prime	.9	.5	1.4	.7	.6	.4	.6	1.0	1.0	17	.9	1.0	.5	.9
,erage size ($1,000)														
Loans above prime	179	200	199	215	183	277	188	336	153	246	290	585	273	270
Loans below prime	8,936	2,907	4,022	1,176	3,197	2,940	1,488	581	971	1,634	2,015	498	2,981	2,628

--preliminary

JTE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

Table 4

Selected Characteristics of Gross
Short-term C&I Loans Extended by Large Non-Money Center Banks

	1977				1978				1979				1980^P	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
rcentage of gross loan tensions accounted for loans made at														
rates below prime	3.4	3.9	1.5	7.9	10.0	14.8	10.6	22.5	24.2	35.1	22.8	8.8	40.5	31.8
rates below money market rates 1/	.0	.0	.5	.3	.1	.4	.1	4.3	2.1	1.5	.9	2.9	2.6	1.2
rates below prime and not under commitment	.1	.5	1.0	4.4	6.5	6.2	3.5	13.8	9.1	12.8	10.8	2.2	16.9	9.9
erage maturity (months)														
Loans above prime	1.9	1.7	2.8	2.4	2.3	2.3	2.4	2.7	2.4	2.7	2.5	2.6	2.1	2.7
Loans below prime	.1	.9	4.0	1.3	.8	.5	.7	2.9	1.3	.7	1.2	1.6	.6	1.1
erage size ($1,000)														
Loans above prime	110	142	142	132	116	125	128	134	126	132	140	225	184	154
Loans below prime	540	1,152	170	492	476	900	158	240	269	540	338	64	437	274

--preliminary

TE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

made by the commercial paper market and finance companies. In 1977, Morgan Guaranty announced a "commercial paper adjustment facility" designed to provide large sums of credit for very short periods (usually no more than 10 days) to those of its customers having lines of credit used to secure borrowings in the commercial paper market. Similar credit facilities also were made available by other large banks. These programs were designed to allow customers to adjust the timing of their paper issuance in order to obtain the best terms possible. The price of these funds is set at a markup over their cost to the bank, typically as measured by the federal funds rate. Reports suggest that very short-term credit is also available in large volume at rates marked up over the commercial paper rate itself.

The market for such short-term below prime loans is described as very impersonal, with no sense of loyalty between lender and borrower. Money center banks make the funds available only if they cannot be more profitably employed elsewhere, while borrowers tend to "shop around" from bank to bank, and in the commercial paper market itself, in search of the cheapest source of credit. Generally less than a third of below prime lending at money center banks is done under commitment.

The importance of this type of lending by money center banks is illustrated by declines in the relative volume of their below prime lending when money market rates approach the prime rate, as happened in the fall of 1978 and again a year later (see chart 1). The surveys of November 1978 and November 1979 show sharp declines in the percent of loans made at rates below prime at money center banks. Moreover, about a quarter of the below prime loan made by these banks during these periods were priced below money market rates. Apparently, many of the "below prime" loans made

Table 5

Selected Characteristics of Gross
Short-term C&I Loans Extended by Large NYC Banks

	1977				1978				1979				1980^{p}	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
centage of gross loan ensions accounted for loans made at														
rates below prime	14.0	7.7	26.6	14.4	24.7	20.5	25.9	19.1	50.9	49.0	46.9	26.5	67.0	67.0
rates below money market rates 1/	.0	.5	1.2	.0	.0	.0	.1	4.5	2.3	2.2	1.0	9.4	.2	.4
rates below prime and not under commitment	14.0	5.2	21.0	8.9	21.0	14.1	14.8	13.8	38.4	33.1	38.1	20.5	46.4	45.0
rage maturity (months)														
Loans above prime	1.3	1.3	1.8	1.3	1.7	1.5	1.8	1.6	1.5	2.2	1.5	1.6	1.7	2.2
Loans below prime	1.1	.7	1.4	.6	.5	.3	.3	.8	.9	.6	.8	.9	.4	.9
rage size ($1,000)														
Loans above prime	231	284	261	251	300	310	269	329	182	347	365	535	338	310
Loans below prime	10,760	4,622	4,428	2,061	3,752	3,652	607	641	1,229	2,581	2,045	1,087	4,054	2,181

-preliminary

TE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

Table 6

Selected Characteristics of Gross Short-term C&I Loans Extended by Large Non-NYC Banks

	1977				1978				1979				1980^{P}	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
:centage of gross loan :ensions accounted for loans made at														
rates below prime	4.0	3.5	1.8	6.6	8.7	7.2	8.4	20.3	22.0	28.6	25.0	12.1	31.5	51.7
rates below money market rates 1/	1.5	.0	.4	.5	.1	.3	.1	3.2	3.1	1.2	.5	2.4	2.1	.9
rates below prime and not under commitment	1.8	.5	1.2	3.8	.5	2.3	4.0	8.6	7.9	11.9	7.0	5.1	7.1	7.6
ırage maturity (months)														
Loans above prime	2.6	2.2	2.8	2.6	2.7	2.6	2.6	3.0	3.0	3.1	2.9	2.4	2.6	2.8
Loans below prime	.1	.8	2.9	1.4	1.1	.6	1.4	2.6	1.6	.9	1.4	1.5	.8	1.0
erage size ($1,000)														
Loans above prime	115	127	134	139	110	145	121	169	124	131	142	293	193	173
Loans below prime	863	468	234	421	513	601	245	272	273	437	447	97	416	828

-preliminary

TE: Calculations are based on the prevailing prime rate. Actual primes, available since August 1979, are identical to the prevailing prime except for May 1980. See appendix table 1.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

by money center banks in November 1978 and November 1979 reflect the honoring of previous loan commitments featuring cap provisions, as the prime rate had been rising rapidly prior to both of these surveys.

At large non-money center banks (table 4), the average size of loans made below prime is only somewhat larger than other loans, and loans generally are much smaller than at money center banks. In addition, the disparity between the maturities of loans made below prime and those made at or above prime by these banks generally is not as pronounced as at money center banks. Finally, the share of below prime loans made under commitment is larger at large non-money center banks than at money center banks.[1]

III. Medium and Smaller Banks

Below prime lending at medium sized and smaller banks has been substantial in all the surveys since November 1978. In contrast to the situation at large banks, a significant part of below prime lending at these other banks has been done below money market rates (see table 7). This pricing appears to reflect the tendency for loan rates at smaller banks, particularly on smaller loans, to adjust to general upward rate pressures much more slowly than the prevailing prime rate and other money market rates. In part, this sluggishness may arise from cap provisions on the larger share of below prime loans made under commitment by these banks. Increases in the proportion of loans made at rates below prime by medium and smaller banks in November 1978 and November 1979, for example, were likely due in part to the sharp upward movements in interest rates that had been in train for some time before each

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[1] Table 5 and 6 show similar patterns for large banks located in New York City compared to large banks elsewhere. Of course, the similarities between the large money center and large New York City bank categories is in part attributable to their overlapping coverage.

Table 7

Selected Characteristics of Gross Short-term C&I Loans Extended by Medium Sized and Smaller Banks

	1977				1978				1979				1980^p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
rcentage of gross loan tensions accounted for loans made at														
rates below prime	1.8	2.2	3.2	4.9	3.7	7.0	7.7	23.5	30.6	24.6	32.9	45.5	32.8	43.3
rates below money market rates 1/	.1	.0	.7	.7	1.1	.8	1.5	6.7	13.0	11.3	17.8	26.0	11.9	2.3
rates below prime and not under commitment	.5	.8	1.1	2.4	1.5	4.7	5.9	14.6	19.7	17.6	22.5	32.7	25.7	27.0
rerage maturity (months)														
Loans above prime	2.7	2.3	2.1	2.4	2.3	2.0	2.5	1.3	2.6	2.3	2.2	2.3	2.5	2.7
Loans below prime	1.0	1.0	2.0	1.1	1.2	2.8	2.4	2.3	2.7	2.9	2.7	3.0	2.5	2.8
rerage size ($1,000)														
Loans above prime	27	28	35	30	29	31	34	69	41	39	40	61	52	56
Loans below prime	195	447	78	59	57	51	14	28	20	15	20	23	19	32

--preliminary

JTE: Calculations are based on the prevailing prime rate. For calculations using the actual prime, available since August 1979, see table 7a.

1/ The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

Table 7a

Selected Characteristics of Gross
Short-term C&I Loans Extended by Medium Sized and Smaller Banks

	1979		1980^p	
	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
Percentage of gross loan extensions accounted for by loans made at				
- rates below prime	21.2	26.6	15.2	26.8
- rates below money market rates[1/]	7.9	15.9	5.6	2.2
- rates below prime and not under commitment	12.9	16.9	9.2	14.4
Average maturity (months)				
- Loans above prime	2.4	2.3	2.5	2.7
- Loans below prime	2.4	3.4	2.6	2.7
Average size ($1,000)				
- Loans above prime	34	36	36	40
- Loans below prime	22	33	23	46

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p--preliminary

NOTE: These calculations reflect the actual prime rate in effect at respondent banks on survey dates.

[1/] The money market rate benchmark is the lower of the federal funds rate and the commercial paper rate.

of these survey weeks. The increase in below prime lending during these survey weeks contrasts with simultaneous declines in the share of loans made below prime at money center banks. As discussed above, the strong upward rate pressures that characterized these periods had brought money market rates into close proximity with the prime rate, causing the rate on loans tied to money market rates to approach or exceed the prime rate.

At medium and smaller banks, the average size and maturity characteristics of loans made below prime tend to be quite similar to those for loans made at prime and above. Indeed, to the extent that they differ, below prime loans at these banks tend to have longer maturities and smaller average sizes than other loans—the opposite of the situation at large banks.

IV. Implications of Relative Maturity

As already noted, gross loans made below prime by money center banks have very short average maturities relative to their other short-term loans and to short-term loans made at other banks. This large disparity in average loan maturities makes it difficult to use gross extensions data to infer anything about the share of outstanding bank loans that were made at rates below prime. Consider, for example, a bank whose outstanding loans are equally divided between those made at rates of prime and above those made at rates below prime. If, in addition, the average maturity of loans made below prime were half that of loans made at or above prime, then gross loan extension data would show that the volume of loans made below prime was twice the volume made at prime or above. In general, since loans with shorter maturities tend to be made more often their importance in gross extensions data will exaggerate the share of a bank's portfolios for which they account.

To obtain some indication of the proportion of outstanding bank credit accounted for by loans made at rates below prime, the percentages of loans made below prime were recalculated after adjusting the gross loan extension data for differing loan maturities. The results of this adjustment, presented in table 8, show substantially reduced proportions of loans made below prime at large banks--typically lower by a factor of about 1/2--and generally higher proportions for medium and smaller banks, where average maturities of below prime loans have tended to exceed somewhat average maturities of loans made at or above prime in recent surveys.[1] The adjusted percentages suggest that lending at rates below prime did not reach sizable proportions at large banks until late 1978, about the same time as at smaller banks. Removing the effect of maturity differences also indicates that below prime lending was more extensive at medium sized and small banks than at 48 large banks for every survey since that of May 1978, calculated on the basis of the prevailing prime. When the prevailing prime is replaced by the actual prime, below prime lending is more prevalent at large banks than at medium and smaller banks in May 1980.

V. Loan Rates by Size of Loan

Many of the developments discussed above can also be seen in the behavior of rates classified by size of loan. The relative cost of credit for various sizes of loans has changed considerably in recent years. As

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[1] The percentages calculated in table 8 are based on the volume of loans made below prime adjusted to account for the difference between the average maturity of these loans and that of all loans surveyed. Specifically, to adjust for the contribution that the maturity of loans makes to the frequency with which they appear, on average, in gross loan extensions data, the ratio of a bank's gross loan extensions made at rates below prime to total gross loan extensions (the unadjusted proportion of loans made below prime) was multiplied by the ratio of the average maturity of loans made at rates below prime to the average maturity of all loans made by the bank.

Table 8

The Percent of Gross Short-term C&I Loan Extensions Made at Rates Below The Prevailing Prime By Selected Classes of Banks (Adjusted for Maturity) 1/

Class of Bank	1977				1978				1979				1980^p	
	Feb. 7-12	May 2-7	Aug. 1-6	Nov. 7-12	Feb. 6-11	May 1-6	Aug. 7-12	Nov. 6-11	Feb. 5-10	May 2-7	Aug. 6-12	Nov. 5-10	Feb. 4-9	May 5-10
48 Large	3.1	1.7	9.1	4.4	5.1	3.0	5.1	16.2	18.8	14.7	20.6	10.8	18.6	34.0
13 Money Center	4.8	1.3	17.3	4.0	6.0	2.4	6.7	8.5	21.8	15.5	26.6	15.3	20.9	43.4
Large Non-Money Center	.2	2.1	2.0	4.6	3.9	3.8	3.5	23.9	15.2	12.8	12.4	5.7	15.3	15.6
New York City	11.8	4.1	22.6	7.2	8.9	5.4	6.2	10.1	36.8	19.9	31.5	16.3	32.7	45.5
Large Non-NYC	.2	.5	1.9	3.7	3.5	1.9	4.6	18.1	12.9	10.8	14.0	8.0	12.1	27.1
Medium and Smaller	.6	.9	3.0	2.4	1.9	9.2	7.2	36.0	31.2	29.1	38.1 (21.8) 2/	52.3 (35.0) 2/	32.8 (15.8) 2/	44.4 (26.9) 2/

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p--preliminary

1/ Percentages from row 1 of tables 2-7 were adjusted by multiplying them by the ratio of the average maturity of loans made at rates below prime to the average maturity of all loans. See text, p. 7, for a fuller explanation.

2/ These percentages reflect the actual prime rate posted by respondent banks and are based on the data in table 7a. With the exception of May 1980, at 48 large banks actual primes do not differ from the prevailing prime. For calculations using the actual May 1980 prime at the several classes of large banks, see appendix table 1.

shown in chart 2, the general increases in all interest rates from 1977 through 1979 were reflected least in rates on smaller denomination loans. As a result, the spreads between average rates on smaller loans and on the largest loans at all banks narrowed over this period and actually reversed by late 1979. That is, in November 1979 and February 1980, the average rate on the largest loans, even including many below prime loans, exceeded the average rate on the smallest loans. To the extent that relative size of borrower can be inferred from relative size of loans, smaller borrowers, on average, acquired credit more cheaply in late 1979 and early 1980 than large borrowers.[1] This reversal occurred even earlier if loans having a maturity of one month or less are excluded when calculating average rates by size of loan. On this basis, the average rate on very large loans was above that of small loans in three of the four survey weeks in 1979 and remained above through May 1980 (see chart 3).

Several factors may have contributed to these changes in relative rates on large and small loans.[2] Borrowers of large amounts of funds typically find the cost of bank credit moving in concert with rates generally, since banks price larger loans—even apart from those directly linked to money market rates—competitively to reflect the cost of funds in money markets. The rate on large loans moved fairly closely with the prime rate over the 1977-79 period. Smaller borrowers, on the other hand, often acquire funds from smaller banks, and for many of these banks a relatively substantial share of their lendable funds

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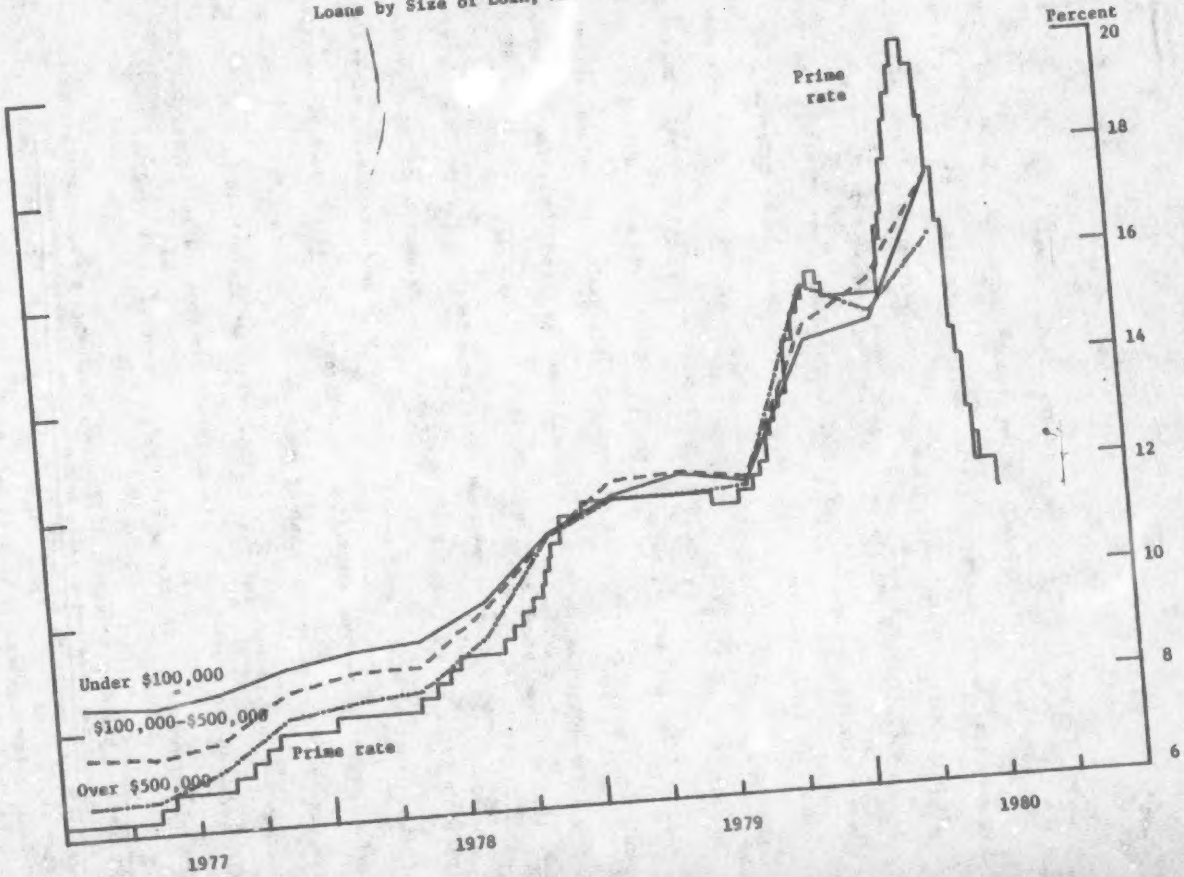
[1] Research based on a special 1972 survey indicates a strong average relationship between loan size and size of borrower, as measured by total assets. "A Model of Bank Lending to Business" by R. Puckett and M. Scanlon (mimeo, Board of Governors).

[2] Smaller loans generally tend to have higher interest rates than large loans owing to the higher per dollar expenses of origination and servicing they impose on banks as well as to relative risk considerations.

Chart 2

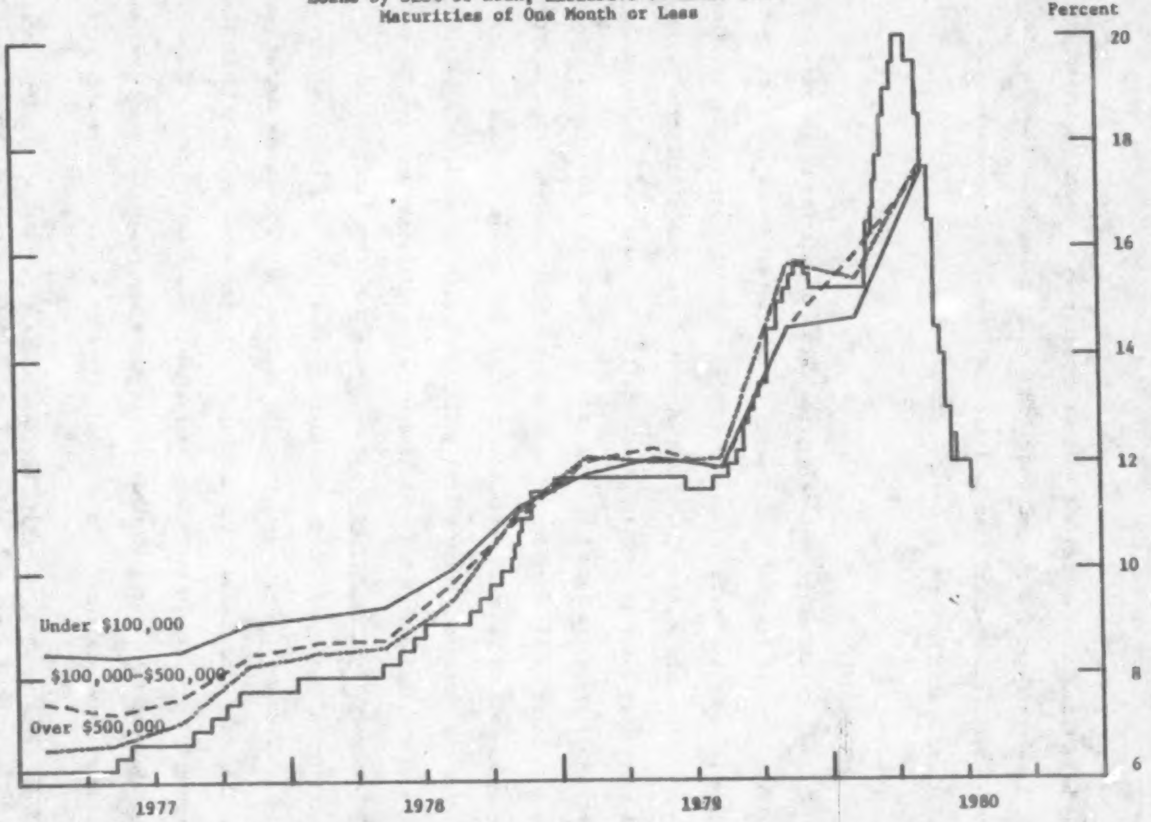
The Average Cost of Short-term Business Loans by Size of Loan, All Loan Maturities



Source: STBL

Chart 3

The Average Cost of Short-term Business Loans by Size of Loan, Exclusive of Loans with Maturities of One Month or Less



Source: STBL

may be obtained from demand and savings deposits whose costs do not vary greatly in the short run. Sluggish movements in average rates on small loans also likely reflect "two-tier" loan policies and other loan programs adopted by both large and small banks to aid small borrowers.[1]

VI. Conclusions

Traditionally, a bank's prime rate has referred to the rate of interest offered its most creditworthy customers, and banks appear to continue to use a base rate in pricing a large share of their lending activities. However, the data examined in this report indicate that significant volumes of short-term loans at both large and small banks have been made below the prime rate since the second half of 1978. In part, this development appears to be related to the environment of high and rising interest rates in which it appeared. If interest rates remain relatively low or continue to fall during the recession, below prime lending at medium and smaller banks—in part attributable to the establishment of special loan programs for smaller businesses, with base lending rates set below the prime rate, and to the extension of loan commitments with maximum rates that were surpassed by the rapidly rising prime rate—is likely to decline. At large money center banks, on the other hand, below prime lending is also traceable to the substantial growth in very large, short-term loans tied to money market rates, suggesting that below prime lending at these institutions may remain important even as interest rates stabilize. An extended period of stable or declining rates is also likely to see the reemergence of a more typical relation between rates on large and small loans, and the average rate on very large loans, even defined to exclude loans with maturities of a month or less, is likely to fall below that for small loans.

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[1] As of early 1979, the Small Business Administration had identified over 100 banks—about a fifth of them very large banks—that had established two-tier loan programs. Typically, these programs use a base rate of 1-1/4 to 1-1/2 percentage points below the prevailing prime to price loans to small businesses. More recently, responses by large banks to surveys taken under the Special Credit Restraint Program indicated that about half of these institutions had established a program to assist small businesses.

Appendix Table 1

Lending Characteristics For Selected Classes of Banks
Calculated on the Basis of Actual Prime Rates Posted, May 5-10, 1980

	Class of Bank				
	48 Large	13 Money Center	Large Non-Money Center	Large NYC	Large Non NYC
Percentage of gross loan extensions accounted for by loans made at					
- rates below prime	53.0	61.1	32.0	60.7	44.3
- rates below prime and not under commitment	25.4	31.4	9.8	42.0	6.8
- rates below prime, and adjusted for maturity 1/	30.1	38.3	16.1	38.5	24.4
Average maturity (months)					
- Loans at or above prime	2.5	2.4	2.7	2.1	2.9
- Loans below prime	1.0	.9	1.1	0.8	1.1
Average size ($1,000)					
- Loans at or above prime	205	264	154	342	156
- Loans below prime	1,091	2,632	278	2,726	568

1/ See footnote 1, table 8.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 17, 1980

The Honorable Henry S. Reuss
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Chairman Reuss:

As earlier promised, I am enclosing a detailed staff study of the data we collect on interest rates charged on short-term business lending by banks over recent years.

The study clearly indicates that much of the explanation for the phenomenon you noted of larger volumes of "below prime" lending at New York City and other large banks during recent quarters can be explained by very large loans of very short maturity. The share of those loans in banks' lending activity has increased in recent years as large banks have competed more actively with the open market -- particularly the commercial paper market -- to accommodate the very short-term financing requirements of businesses; and interest rates on such loans are therefore very closely related to money market rates. This approach, dating back at least to 1977, was initially developed to provide customers using commercial paper with transitional facilities to bridge gaps of a few days in commercial paper issuance.

Thus, the bulk of below-prime business at large banks is related to a special market that does not involve smaller loans or indeed large loans with maturities of more than a few days or weeks. After allowing for this factor, experience among banks of different size is much more comparable. Because these particular below-prime loans have such short maturity, their relative position in banks' portfolios is, of course, much less than would be indicated by their share in the volume of new extensions over any time interval.

I believe it is reasonable to, in effect, adjust the data for this activity with large borrowers -- borrowers which, in any event, have access to the commercial paper market. The question remains as to the situation with respect to more usual loans extending over longer periods. The study does not clearly indicate a more favored position for large borrowers in the market for credit at maturities that are more typically relied upon by both large and small borrowers. In fact, the average cost of short-term business loans maturing in more than a month has risen more for large loans than for small loans over the last three years, and at the peak rate period, rates for large loans appear to have exceeded those for small.

Analysis of these data is necessarily obscured by lack of information about precisely how many loans, and their distribution by size, during rising rate periods may have been made under preexisting commitments having interest rate "caps." However, the data appear consistent with other indications that special loan programs for smaller businesses were one factor in moderating increases for those borrowers during periods of peak rates.

In sum, the data you cited in your letter do not themselves appear to justify sweeping charges of discrimination against particular groups of borrowers. A more subtle question that cannot be conclusively answered on the basis of available data remains as to whether the prime rate is somewhat less indicative of the minimum rate on the "best" ordinary business loans (i.e., those of more than a few days or weeks maturity) than the nomenclature implies. Moreover, I would note a lag in a reduction of the prime rate relative to short-term market rates may work in some instances to the relative disadvantage of customers that do not have access to the open market for large short-term business credit.

Sincerely yours,

Paul

Enclosure

Mr. **LaFalce**. Thank you very much.

I would like to continue this, but I do want to hear from Administrator Cardenas.

Gentlemen, I want to thank you so much for your testimony. It has been very, very helpful.

I am going to give you three options. You can leave the table and go home; or you can leave the witness table and sit in the back of the room, or you can remain at the witness table and be joined by Mr. Cardenas. Then after Mr. Cardenas makes his comments, you might want to make some comments on them. The choice is yours, but make them within the next 10 seconds.

[Laughter.]

Mr. **Bolt**. I will opt for the back of the room.

Mr. **Ruch**. I think so.

Mr. **LaFalce**. Because of the importance of this vote, the subcommittee will take a 10-minute recess. We will return at 5 minutes to 11.

[Recess.]

Mr. **LaFalce**. The subcommittee will resume its session.

Mr. Cardenas, we have introduced the entire text of your remarks in the record already. You may proceed to summarize your remarks, or give your full testimony, as you desire.

TESTIMONY OF MICHAEL CARDENAS, ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY EDWIN T. HOLLOWAY, ACTING ASSOCIATE ADMINISTRATOR FOR FINANCIAL ASSISTANCE

Mr. CARDENAS. Thank you, Mr. Chairman, and members of the subcommittee and staff.

We are all specifically concerned about the level of interest rates charged on our private sector lending partners for SBA guaranteed loans. I would like to say that I would be the first to admit that I share the subcommittee's great concern about the current level of interest rates.

The Small Business Administration's policy when setting an interest rate ceiling is to keep participant interest rates as low as possible and still provide the necessary incentive to encourage lenders to lend to new small business ventures and other small businesses.

The lender resistance that SBA must overcome stems from several factors. The first factor, of course, is that many lenders are near their maximum loan-to-deposit ratios. Therefore, any loans in participation with SBA represent funds that will not be available for the lender's best customers.

Another factor is the potentially greater cost. Since the Small Business Administration is the lender of last resort, our loans are, from a lender's viewpoint, very weak credits that are prone to losses. Further, when a borrower fails, the lender incurs the costs of liquidation.

A third factor is that lenders generally make short-term, not long-term, loans. Our purpose is to encourage lenders to provide the long-term credit that many small businesses need.

Lenders can make loans to their best customers at the prime rate. To provide the necessary incentive to use funds to assist small business, the ceiling on the lender's interest rate was established above the prime rate. Between May 1962 and September 1979, the agency established a fixed rate ceiling on a lender's interest rate. This ceiling was based, in part, on the published prime and, generally, was greater than the prime rate.

Historically, the prime rate has been the one factor that the agency always has considered when setting a ceiling on the maximum interest rate a lender may charge. Until recently, there was nothing to make the public doubt that the prime rate was anything but what the financial markets claimed it to be. Now there is a growing body of evidence or assertions that the prime rate does not necessarily reflect the rate the bank's best customers are charged. There are indications that some such loans are actually being made at rates below the quoted prime.

Because of the recent uncertainty of what the quoted prime rate really represents, the agency is looking at other rates representing the credit market that could be used as a base for establishing the ceiling on the lender's rate of interest on SBA guaranteed loans. However, we have considered using the Federal funds rate, the discount rate, or the call money rate as a base. While these rates are all readily available, clearly recognizable and available daily, we are not fully convinced that they are any more reflective of actual money market conditions, any less subject to manipulation, or any more equitable than the present base being used.

I have, therefore, approved a notice of intent which will be published in the Federal Register shortly. In this notice, although we are continuing to use the money center prime as our base, we are asking for public suggestions on other readily available indicators that would be used to replace the prime rate as a base for establishing the ceiling on the lender's rate of interest.

As regards the appropriateness of using the prime rate, we believe that the base rate used to compute the lender's interest rate ceiling must (a) be widely available and readily recognizable to the general public from some source other than the lender, and (b), be available every business day. The money center prime rate printed in the Wall Street Journal meets these two requirements. The agency has no reason to question the appropriateness of using the prime rate for this purpose until recent findings and indications placed a cloud over the accuracy of this base. Whatever base is used, however, these prerequisites must be met.

In support of this administration's concern over high interest rates, the Small Business Administration's field office personnel constantly strive to get our borrowers the lowest feasible interest rate for which each credit qualifies. The table at the end of this statement reflects the results of our agency's efforts and shows that our guaranteed loans are made at a variety of interest rates as negotiated between the private sector lenders and the borrowers.

The notice of proposed rulemaking that I have approved also reflects agency proposals for reducing interest rates that lenders may charge. This proposal, as I indicated earlier, will be printed in the Federal Register for public comment.

My staff and I have considered several rates that might be used as a base. Also, the notice of intent, as previously mentioned, is asking the public to suggest and justify a more equitable base for the agency's use in establishing the interest rate ceiling. The subcommittee also has expressed an interest in our plans concerning the guarantee percentage on 7(a) loans.

Jumping now to the guarantee portion inquiry, earlier in the year, because of the anticipated reduction in our fiscal year 1981 guarantee authority, our field offices were advised to take all appropriate action to reduce activity accordingly. Some regional and district offices reacted by adopting a policy that the Small Business Administration would guarantee no more than 75 percent of any loan.

As I wrote Chairmen Mitchell and Weicker earlier this month, I notified all field offices on July 17 that, while such action was appropriate at the time, we now are able to allocate sufficient guarantee authority for the balance of this fiscal year so that such across-the-board policies are no longer appropriate and should be rescinded.

I further advised the field offices that decisions to guarantee less than the percentage a lender requests must be dealt with on a case-by-case basis. At the same time, the Small Business Administration does want to encourage increased private lender involvement in small business lending. We have not, however, finalized any plan for increasing the lender's percentage of participation since pending legislation could influence our ability to act in this area.

Mr. Chairman, I would also like to briefly recap what the elements of our proposals are that will be stated in the Federal Register.

The first one, of course, would be regarding the interest rate that can be charged, and the second, the participating lenders be allowed to use their own prime interest rate as a base for computing fluctuations on variable interest rate loans provided, first, the lender's prime rate is published daily in a news publication of general circulation within its service area; two, that the initial rate does not exceed the maximum allowable rate; and third, the spread between the lender's prime rate and the initial note rate is maintained during the life of the loan.

The third element is that the note rate on a variable interest rate can fluctuate upward or downward no more frequently than once a day, commencing one day after the note is signed and the loan is closed. I think that problem was alluded to earlier by a previous witness.

Four, that participating lenders not be required to notify SBA of fluctuations in the rate for variable interest rate loans.

Fifth, that the SBA optional PEG rate no longer be allowed as a base for determining fluctuations in variable interest rate loans.

Mr. Chairman, this concludes my presentation. I have with me Mr. Holloway, who will answer questions along with me in the event I would have to leave for the Senate hearing.

[Mr. Cardenas' prepared statement and attachments follow:]

Prepared Statement of Michael Cardenas, Administrator, Small Business Administration

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, IT IS A PLEASURE TO BE HERE THIS MORNING. WHEN I ARRIVED AT THE SMALL BUSINESS ADMINISTRATION SOME FOUR MONTHS AGO, I IMMEDIATELY RESOLVED TO COMPLETE AN ACROSS THE BOARD REVIEW OF ALL MAJOR PROGRAMS, POLICIES AND ISSUES AFFECTING THE AGENCY'S DELIVERY OF NEEDED ASSISTANCE TO ELIGIBLE SMALL BUSINESSES. OF COURSE, WE ARE SPECIFICALLY CONCERNED ABOUT THE LEVEL OF INTEREST RATES CHARGED BY OUR PRIVATE SECTOR LENDING PARTNERS FOR SBA-GUARANTEED LOANS.

IN DISCUSSING OUR ROLE AS TO INFLUENCING THE INTEREST RATE ON SBA-GUARANTEED LOANS, I SHOULD LIKE, FIRST, TO STATE THAT I SHARE THE SUBCOMMITTEE'S GREAT CONCERN ABOUT THE CURRENT LEVEL OF INTEREST RATES. THEY ARE TOO HIGH. THEY ARE HAVING A DEVASTATING EFFECT UPON MANY SMALL BUSINESSES, AND THIS ADMINISTRATION IS DETERMINED TO HELP BRING THEM DOWN.

IN DESIGNING A PUBLIC POLICY, IT IS IMPORTANT TO UNDERSTAND THE CAUSE OF THE PROBLEM WE ARE TRYING TO CORRECT. THE MAJOR CAUSE OF THE EXTRAORDINARILY HIGH INTEREST RATES OF THE PAST TWO YEARS HAS BEEN INFLATION. THE PRESIDENT HAS PROPOSED A BOLD ECONOMIC RECOVERY PROGRAM. THE CONGRESS, AFTER CAREFUL SCRUTINY, AND AFTER EXERCISING ITS CONSTITUTIONALLY-MANDATED PREROGATIVES, HAS COMPLETED MANY OF THE STEPS INVOLVED IN APPROVING THIS PROGRAM. THE MAJOR PURPOSE OF THE PRESIDENT'S NEW ECONOMIC PLAN IS TO GET INFLATION UNDER CONTROL. CONTROL INFLATION, AND INTERST RATES WILL COME DOWN. AND THAT WILL HELP ALL OF THE MORE THAN 10 MILLION SMALL BUSINESSES IN THIS COUNTRY, INCLUDING THE APPROXIMATELY 30 THOUSAND THAT RECEIVE SBA GUARANTEED LOANS EACH YEAR.

THE SMALL BUSINESS ADMINISTRATION'S POLICY WHEN SETTING AN INTEREST RATE CEILING IS TO KEEP PARTICIPANT INTEREST RATES AS LOW AS POSSIBLE AND STILL PROVIDE THE NECESSARY INCENTIVE TO ENCOURAGE LENDERS TO LEND TO NEW SMALL BUSINESS VENTURES AND OTHER SMALL BUSINESSES. THE LENDER RESISTANCE THAT SBA MUST OVERCOME STEMS FROM SEVERAL FACTORS. ONE FACTOR IS THAT MANY LENDERS ARE NEAR THEIR MAXIMUM LOAN TO DEPOSIT RATIOS. THEREFORE, ANY LOANS IN PARTICIPATION WITH SBA REPRESENT FUNDS THAT WILL NOT BE AVAILABLE FOR THE LENDER'S BEST CUSTOMERS. ANOTHER FACTOR IS THE POTENTIALLY GREATER COST. SINCE THE SMALL BUSINESS ADMINISTRATION IS THE LENDER OF LAST RESORT, OUR LOANS ARE, FROM A LENDER'S VIEWPOINT, VERY WEAK CREDITS THAT ARE PRONE TO LOSSES. FURTHER, WHEN A BORROWER FAILS, THE LENDER INCURS THE COSTS OF LIQUIDATION. A THIRD FACTOR IS THAT LENDERS GENERALLY MAKE SHORT-TERM (NOT LONG-TERM) LOANS. OUR PURPOSE IS TO ENCOURAGE LENDERS TO PROVIDE THE LONG-TERM CREDIT THAT MANY SMALL BUSINESSES NEED. LENDERS CAN MAKE LOANS TO THEIR BEST CUSTOMERS AT THE PRIME RATE. TO PROVIDE THE NECESSARY INCENTIVE TO USE FUNDS TO ASSIST SMALL BUSINESS, THE CEILING ON THE LENDER'S INTEREST RATE WAS ESTABLISHED ABOVE THE PRIME RATE. BETWEEN MAY, 1962, AND SEPTEMBER, 1979, THE AGENCY ESTABLISHED A FIXED RATE CEILING ON A LENDER'S INTEREST RATE. THIS CEILING WAS BASED, IN PART, ON THE PUBLISHED PRIME AND, GENERALLY, WAS GREATER THAN THE PRIME RATE. (SEE THE ATTACHED HISTORICAL TABLE.)

WHEN INTEREST RATES STARTED TO FLUCTUATE WILDLY, BANKING, CONGRESSIONAL AND OTHER SOURCES POINTED OUT THAT LENDERS ARE BORROWING AT SHORT-TERM RATES TO MAKE LONG-TERM LOANS AND THAT OUR POLICY WAS NOT REALISTIC. IN SEPTEMBER, 1979, WE SET A FLOATING RATE CEILING AT NOT TO EXCEED 1/2 PERCENT OVER THE MINIMUM MONEY CENTER PRIME RATE PRINTED IN THE WALL STREET JOURNAL (THIS REPRESENTS THE BANK PRIME IN SEVERAL MONEY CENTERS OVER THE COUNTRY, NOT JUST NEW YORK CITY). IN JULY, 1980, A SPREAD OF EITHER 2-1/4 PERCENT OR 2-3/4 PERCENT OVER THE MINIMUM MONEY CENTER PRIME WAS AUTHORIZED, DEPENDING ON THE LOAN MATURITY.

HISTORICALLY, THE PRIME RATE HAS BEEN THE ONE FACTOR THAT THE AGENCY ALWAYS HAS CONSIDERED WHEN SETTING A CEILING ON THE MAXIMUM INTEREST RATE A LENDER MAY CHARGE.

THE PRIME RATE HAS BEEN REPUTED TO BE, AND UNQUESTIONABLY WAS ACCEPTED AS, THE LOWEST RATE WHICH BANKS CHARGED THEIR BEST CUSTOMERS.. THIS ATTITUDE IS REFLECTED IN THE ANALYSIS THE HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS RELEASED ON APRIL 30, 1981. UNTIL RECENTLY THERE WAS NOTHING TO MAKE THE PUBLIC DOUBT THAT THE PRIME RATE WAS ANYTHING BUT WHAT THE FINANCIAL MARKETS CLAIMED IT TO BE.

NOW THERE IS A GROWING BODY OF EVIDENCE OR ASSERTIONS THAT THE PRIME RATE DOES NOT NECESSARILY REFLECT THE RATE THE BANK'S BEST CUSTOMERS ARE CHARGED. THERE ARE INDICATIONS THAT SOME SUCH LOANS ARE ACTUALLY BEING MADE AT RATES BELOW THE QUOTED PRIME.

BECAUSE OF THE RECENT UNCERTAINTY OF WHAT THE QUOTED PRIME RATE REALLY REPRESENTS, THE AGENCY IS LOOKING AT OTHER RATES REPRESENTING THE CREDIT MARKET THAT COULD BE USED AS A BASE FOR ESTABLISHING THE CEILING ON THE LENDER'S RATE OF INTEREST ON SBA-GUARANTEED LOANS. CONSIDERATION OF BOND RATES HAS BEEN LIMITED BECAUSE SUCH RATES REPRESENT SUPPLY AND DEMAND FORCES IN THE INVESTMENT MARKET AND ARE NOT TRULY REPRESENTATIVES OF FORCES IN THE FINANCIAL MARKETS. HOWEVER, WE HAVE CONSIDERED USING THE FED FUNDS RATE, THE DISCOUNT RATE OR THE CALL MONEY RATE AS A BASE. WHILE THESE RATES ALL ARE READILY AVAILABLE, CLEARLY RECOGNIZABLE AND AVAILABLE DAILY (THE PREREQUISITES FOR ANY BASE USED), WE ARE NOT FULLY CONVINCED THAT THEY ARE ANY MORE REFLECTIVE OF ACTUAL MONEY MARKET CONDITIONS, ANY LESS SUBJECT TO MANIPULATION, OR ANY MORE EQUITABLE THAN THE PRESENT BASE BEING USED. I HAVE, THEREFORE, APPROVED A NOTICE OF INTENT WHICH WILL

BE PUBLISHED IN THE FEDERAL REGISTER. IN THIS NOTICE, ALTHOUGH WE ARE CONTINUING TO USE THE MONEY CENTER PRIME AS OUR BASE, WE ARE ASKING FOR PUBLIC SUGGESTIONS ON OTHER READILY AVAILABLE INDICATORS THAT WOULD BE USED TO REPLACE THE PRIME RATE AS A BASE FOR ESTABLISHING THE CEILING ON THE LENDERS' RATE OF INTEREST.

AS REGARDS THE APPROPRIATENESS OF USING THE PRIME RATE, WE BELIEVE THAT THE BASE USED TO COMPUTE THE LENDER'S INTEREST RATE CEILING MUST (A) BE WIDELY AVAILABLE AND READILY RECOGNIZABLE TO THE GENERAL PUBLIC FROM SOME SOURCE OTHER THAN THE LENDER AND (B) BE AVAILABLE EVERY BUSINESS DAY. THE MONEY CENTER PRIME RATE PRINTED IN THE WALL STREET JOURNAL MEETS THESE TWO REQUIREMENTS. THE AGENCY HAD NO REASON TO QUESTION THE APPROPRIATENESS OF USING THE PRIME FOR THIS PURPOSE UNTIL RECENT FINDINGS AND INDICATIONS PLACED A CLOUD OVER THE ACCURACY OF THIS BASE. WHATEVER BASE IS USED, HOWEVER, THESE PREREQUISITIES MUST BE MET.

IN SUPPORT OF THIS ADMINISTRATION'S CONCERN OVER HIGH INTEREST RATES, THE SMALL BUSINESS ADMINISTRATION'S FIELD OFFICE PERSONNEL CONSTANTLY STRIVE TO GET OUR BORROWERS THE LOWEST FEASIBLE INTEREST RATE FOR WHICH EACH CREDIT QUALIFIES. THE TABLE AT THE END OF THIS STATEMENT REFLECTS THE RESULTS OF THE AGENCY'S EFFORTS AND SHOWS THAT OUR GUARANTEED LOANS ARE MADE AT A VARIETY OF INTEREST RATES AS NEGOTIATED BETWEEN THE PRIVATE SECTOR LENDERS AND BORROWERS.

THE NOTICE OF PROPOSED RULEMAKING THAT I HAVE APPROVED ALSO REFLECTS AGENCY PROPOSALS FOR REDUCING INTEREST RATES THAT LENDERS MAY CHARGE. THIS PROPOSAL WILL SOON BE PRINTED IN THE FEDERAL REGISTER FOR PUBLIC COMMENT.

MY STAFF AND I HAVE CONSIDERED SEVERAL RATES THAT MIGHT BE USED AS A BASE. ALSO, THE NOTICE OF INTENT, AS PREVIOUSLY MENTIONED, IS ASKING THE PUBLIC TO SUGGEST AND JUSTIFY A MORE EQUITABLE BASE FOR THE AGENCY'S USE IN ESTABLISHING THE INTEREST RATE CEILING. THE SUBCOMMITTEE ALSO HAS EXPRESSED AN INTEREST IN OUR PLANS CONCERNING THE GUARANTEE PERCENTAGE ON 7(A) LOANS.

EARLIER IN THE YEAR, BECAUSE OF THE ANTICIPATED REDUCTION IN OUR FISCAL YEAR 1981 GUARANTEE AUTHORITY, OUR FIELD OFFICES WERE ADVISED TO TAKE ALL APPROPRIATE ACTION TO REDUCE ACTIVITY ACCORDINGLY. SOME REGIONAL AND DISTRICT OFFICES REACTED BY ADOPTING A POLICY THAT THE SMALL BUSINESS ADMINISTRATION WOULD GUARANTEE NO MORE THAN 75 PERCENT OF ANY LOAN. AS I WROTE CHAIRMEN MITCHELL AND WEICKER EARLIER THIS MONTH, I NOTIFIED ALL FIELD OFFICES ON JULY 17 THAT, WHILE SUCH ACTION WAS APPROPRIATE AT THE TIME, WE NOW ARE ABLE TO ALLOCATE SUFFICIENT GUARANTEE AUTHORITY FOR THE BALANCE OF THIS FISCAL YEAR SO THAT SUCH ACROSS-THE-BOARD POLICIES ARE NO LONGER APPROPRIATE AND SHOULD BE RESCINDED. I FURTHER ADVISED THE FIELD OFFICES THAT DECISIONS TO GUARANTEE LESS THAN THE PERCENTAGE A LENDER REQUESTS MUST BE DEALT WITH ON A CASE-BY CASE BASIS. AT THE SAME TIME, THE SMALL BUSINESS ADMINISTRATION DOES WANT TO ENCOURAGE INCREASED PRIVATE

LENDER INVOLVEMENT IN SMALL BUSINESS LENDING. WE HAVE NOT, HOWEVER, FINALIZED ANY PLAN FOR INCREASING THE LENDERS' PERCENTAGE OF PARTICIPATION SINCE PENDING LEGISLATION COULD INFLUENCE OUR ABILITY TO ACT IN THIS AREA.

MR. CHAIRMAN, THIS CONCLUDES MY PREPARED REMARKS. I WOULD BE PLEASED TO RESPOND TO ANY QUESTIONS YOU MAY HAVE REGARDING THESE VERY SIGNIFICANT ISSUES.

[Attachment 1]

HISTORY OF MAXIMUM PERMISSIBLE BANK INTEREST RATE

PERIOD BEGINNING:	IP	GP	SBA GP Rate VS Prime	Prime
May 1962	8	8	+3-1/2	4.5
July 1967	8	8	+2-1/2	5.5
October 1969	8	Legal & Reas.		8.5
July 1970	8	Legal & Reas.		8.0
Feb. 1971	7-1/4	7-3/4 (w/excep. to 8-1/2)	+2-3/4	6
July 1971	7-3/4	8-3/4	+3-1/4	5/5
October 1971				6
January 1972	7-1/4	8-1/4	+3-1/2	5.25
April 1972	7	8	+3-1/4	4.75
July 1972	7-1/4	8-1/4	+3	5.25
October 1972	7-1/2	8-1/2	+3	5.5
January 1973	7-3/4	8-3/4	+3	5.75
April 1973	8-1/4	9-1/4	+2-3/4	6.5
July 1973	10	11	+3-1/4	7.75
October 1973	10	11	+1	10.00
January 1974	10	11	+1-1/4	9.75
March 1974	9-1/2	10-1/2	+1-3/4	8.75
Sept. 3, 1974	10-1/2	11-1/2	-1/2	12.00
January 2, 1975	10-1/2	11-1/2	+1-1/2	10.00

Feb. 15, 1975	10	11	+1-1/2	9.5
March 15, 1975	9-1/4	10-1/4	+1-3/4	6.5
July 1, 1975	9-1/4	10-1/4	+3-1/4	7.0
Oct. 10, 1975	9-3/4	10-3/4	+3-3/4	6.0
January 1, 1976	9-3/4	10-3/4	+3-3/4	7.0
April 1, 1976	9-1/2	10-1/2	+3-3/4	6.75
July 1, 1976	9-1/2	10-1/2	+3-1/4	7.25
October 6, 1976	9	10	+3	7.0
January 1, 1977	8-1/4	9-1/4	+2-3/4	6.5
April 1, 1977	8-3/4	9-3/4	+3-1/2	6.25
July 1, 1977	8-1/2	9-1/2	+2-3/4	6.75
October 1, 1977	8-1/2	9-1/2	+2-1/4	7.25
January 1, 1978	9	10	+2	8.0
April 1, 1978	9	10*	+2	8.0
June 7, 1978	9-1/2	10-1/2	+2-1/4	8.5
July 24, 1878	9-3/4	10-3/4	+1-3/4	9.0
October 10, 1978	10-1/4	11-1/4	+1-1/4	10.0
November 14, 1978	10-1/4	11-1/4	+1/4	11.0
January 8, 1979	11	12	+1/4	11.75
Aug. 29, 1979	11	12	-1/4	12.25
September 19, 1979	1% below GP	1/2% above minimum daily prime rate as published in Wall Street Journal.		
July 1, 1980	1% below GP	Maximum of 2-1/4% over mimimum money center (NY) prime rate for less than 7 years maturity; up to 2-3/4% for 7 years or more.		

[Attachment #2]

INTEREST RATE BY REGION

	Fiscal Year 1977				Fiscal Year 1978				Fiscal Year 1979				
Region	8-8.9%	9-9.9%	10-10.9%	Over 11%	8-8.9%	9-9.9%	10-10.9%	11.11.9%	8-8.9%	9-9.9%	10.10.9%	11-11.9%	over 12
1	13	1,379	506		4	674	1297		1	1	190	461	1193
2	115	1,489	472		61	970	1150		3	46	264	415	896
3	51	866	228	1	28	493	761		1	16	185	381	749
4	161	2,149	560		48	1,442	1722	3	7	72	886	720	1389
5	121	1,970	510		62	1,219	1423	3	7	36	537	959	1573
6	89	3,356	953	1	31	1,992	1978		2	82	1209	641	2532
7	128	2,530	371		43	1,885	1320	4	7	136	786	861	989
8	23	1,807	456		8	1,081	1283	1	3	79	388	669	1125
9	0	1,368	569		4	542	1371	0	0	0	137	437	1162
10	1	775	289		0	376	788	45	2	2	77	221	369
Nat'l	702	17,689	4,934		289	10,674	13093	56	33	470	4,659	5841	11,78[illegible]

	Fiscal Year 1980						Fiscal Year to Date: 5/31/81						
Region	10-10.9%	11-11.9%	12-12.9%	13-13.9%	14-14.0%	Over 15	11-11.9%	12-12.9%	13-13.9%	14-14.9%	15-15,9%	16-16.9	Over 17
1	3	20	213	396	225	854	1	4	24	95	164	162	905
2	38	150	423	429	225	741	16	46	54	106	182	169	936
3	12	35	265	399	237	616	4	12	48	103	149	161	765
4	30	84	626	859	439	1177	9	54	170	304	381	311	1127
5	51	181	684	963	588	1636	8	50	153	321	425	408	1498
6	63	84	519	904	533	1237	12	29	113	251	340	363	1326
7	21	118	472	739	484	917	8	41	104	281	321	317	831
8	17	44	315	454	287	824	9	13	68	134	214	191	651
9	2	19	300	496	312	854	1	4	14	37	132	190	999
10	5	13	200	292	189	590	0	3	19	55	122	140	590
Nat'l	242	748	4017	5921	2519	9446	68	256	768	1687	2430	2426	9628

Mr. LaFalce. Thank you very much, Mr. Cardenas.

Could you go through your attachments, please, and try to explain them a little bit better?

Mr. Cardenas. Ed, why don't you do that.

Mr. Holloway. All right.

Mr. Chairman, if I may, sir, I am Edwin Holloway, Acting Assistant Administrator for Financial Assistance. Attachment No. 1 traces back to 1962 the maximum or ceiling percentage figure that we have permitted on SBA guaranteed loans, and that column is identified as GP or guaranteed percentage.

Over on the right-hand side you see a number that was the prime rate at that time. Between the two numbers is the number that indicates what our spread was over prime. Now, prime, immediate participation, not solely guaranteed but like the bank puts up half the money and we put up half. So the guaranteed loans are that GP column.

So although at that time, from 1962 until 1979, there was no formal tie-in between the prime rate and our maximum permitted rate, nonetheless senior management looked at prime as well as other factors. So we have indicated a spread above prime that our maximum represented for each of these times down to the present.

Now, that is attachment No. 1. Would you like me to move on to attachment No. 2 or——

Mr. LaFalce. Well, let's stick with this a minute.

This is the maximum permissible——

Mr. Holloway. The maximum permitted rate.

Mr. LaFalce. Were there times when your maximum permissible bank rate was below the prime? For example, I am looking at September 1974.

Mr. Holloway. Yes; that's correct. At that time, the maximum permissible rate was 11½ percent.

Mr. LaFalce. And in August 1979?

Mr. Holloway. And in August 1979.

Mr. LaFalce. What was your experience at those times when the maximum permissible rate was below the prime, or approximated the prime, insofar as the number of guaranteed loans that were given out by SBA? Did they cease to exist, were they about the same as had been the case before, or were they greater?

Mr. Holloway. Mr. Chairman, I could not really give you the rationale that was used at that time. We did have access to the facts——

Mr. LaFalce. Attachment 1, in and of itself, doesn't tell me anything very useful. What conclusions can I draw from the data on attachment 1, standing alone?

Mr. Holloway. Standing alone, you can see that, in general, the SBA maximum permitted guaranteed rate has been some two points above prime.

Mr. LaFalce. Yes; but that doesn't enable me to evaluate it and draw any conclusions.

Mr. Cardenas. I think it does state merely that we have always been consistently over prime on an average, probably two point——

Mr. LaFalce. Well, yes. But you have gone from one-half percent below to one-half percent above, to 3½ above, to 3¾ percent above. It doesn't seem to me that I can draw any conclusions from this. I can draw facts from it, but how do I interpret them? What course of action can it lead me to in the future?

Anyway, let's go through attachment No. 2.

Mr. **HOLLOWAY**. Attachment No. 2 reflects by fiscal year, both nationally and by individual regions, the numbers of loans that were made in each of the indicated interest rate categories. We were, I believe, requested to furnish the information in both attachment No. 1 and attachment No. 2 in the letter of invitation to us.

Mr. **LAFALCE**. What I wanted was the number of loans that were given using a bank interest below prime, above prime, et cetera. Is it the general tendency of banks to give loans at prime plus the ceiling? Or, because prime plus the ceiling has been the maximum permitted, do they follow that and go considerably below it, or do they follow it and give at that benchmark?

Mr. **CARDENAS**. It appears to vary, Mr. Chairman. It appears there are many times—particularly now, I think most of the loans being made, as I understand it, are in the 15- to 18-percent category. So obviously they are not sticking with the prime, plus 2¾.

Mr. **LAFALCE**. Are most of the loans being made right now from 15 percent to 18-percent interest rate?

Mr. **HOLLOWAY**. Let me give you, if I may, the figures, Mr. Chairman. These were furnished to your staff from a special computer run, run for the purposes of this hearing.

In fiscal 1981, the first 6 months of this year, loans being made by banks at over 21 percent comprise 20 percent of all the activity. Loans being made at 20 to 20.9, 7.8 percent. Loans at 19 to 19.9, 6.2 percent. Loans at 18 to 18.9, 6.7 percent. Loans at 17 to 17.9, 6.6 percent. Loans at 16 to 16.9, 15.4 percent. Loans at 15 to 15.9, 16.4 percent. Loans at 14 to 14.9 percent, 12 percent. Loans at 13 to 13.9 percent, 6.5 percent. And even 2.4 percent of our loans are being made at under 13 percent.

So the field offices do exercise a negotiating role of sorts to help facilitate the lowest interest rate possible that will still attract the bank to put up the money.

Every telegram that we send out establishing periodically what our rate is stresses that.

Mr. **LAFALCE**. We do not have the breakdown that you are speaking of. That is not your attachment 2. You are reading from something else, and my staff tells me we were never given that document.

Mr. **HOLLOWAY**. You were given the computer run, which I understand, Bruce, you made your own analysis on.

Mr. **FREED**. No; we received the attachment 2, which was the interest rate by region and by fiscal year.

Mr. **HOLLOWAY**. You did not receive this computer run?

Mr. **FREED**. No; I did not.

Mr. **HOLLOWAY**. It was furnished to your office.

Mr. **LAFALCE**. Well, could you give us another copy, please?

Mr. **HOLLOWAY**. Yes, sir. You may have this one.

Mr. **LAFALCE**. Does this computer run relate the loan to the prime rate at the time that either the application was made or at the time the loan was granted?

Mr. **Holloway**. The particular computer run does not, because the prime, per se, is not in our computer. The prime rate information is available to be matched up with this information.

Mr. **LaFalce**. Well, that's the whole point. If we have a prime that is changing from week to week, we can't draw the conclusions we would like. We want to match up what the loans are being guaranteed by SBA with what the prime is as of the time that the loan is granted. That is the relevant information that we need, and we would ask you to supply it. Even this computer printout doesn't provide it.

Mr. **Holloway**. It really supplies what we were asked for, which was for fiscal 1979, fiscal 1980, and fiscal 1981, an array of the interest rates actually charged by loans under $100,000, loans from $100,000 to $249,999——

Mr. **LaFalce**. Do you now understand what I'm asking for?

Mr. **Holloway**. I understand, Mr. Chairman. But I would point out that the prime rate does not remain static all year. For example——

Mr. **LaFalce**. I know. That is precisely my point, and that is exactly the information I am asking you to give this subcommittee.

I am asking you to go back for some reasonable period of time—say the past 6 months or so—and try to find out the interest rate that was charged with an SBA guaranteed loan and what the prime rate was.

Mr. **Cardenas**. At the time the loan is made?

Mr. **LaFalce**. Yes; I would think that is more relevant than at the time of the application.

I am now counseled, though, that your regs do speak of a ceiling of 2¾ percent above prime, with the prime to be looked at being the one at the date of application.

Mr. **Holloway**. That is correct.

Mr. **LaFalce**. What is the prime that is looked upon by the banks? Do the banks usually give a loan based upon the date of the application or the date of the loan? It would seem to me that if at the date of the application there is a 15-percent prime followed by a precipitous increase, in 3 months if the prime is 20 percent, most banks are going to give the loan at 20-plus rather than 15.

Is it SBA's practice at that time to resubmit an application?

Mr. **Holloway**. Mr. Chairman, the application we are speaking to is not the application of the borrower to the bank. It is the application of the bank to SBA for our guaranty. It is on the day they send it forward to us, when they have done all their processing and have done everything they can do, and they say "I want to approve this loan subject to SBA guaranteeing it," they send it forward to our field office. At that time the rate that is negotiated between the borrower and the bank is the rate that they apply for our guarantee on, provided it is a legal and reasonable rate, legal being according to State statute, and reasonable being no greater than our ceiling rate.

Mr. **LaFalce**. And could this final application be submitted even after all the work is done and all the negotiations have taken place?

Mr. **Holloway**. Yes, sir.

Mr. **LaFalce**. In fact, it usually is?

Mr. **Holloway**. It usually is.

Mr. **LaFalce**. So there wouldn't be very much time, then, between the submission of the final application from the bank to SBA, although there may have been a considerable period of time from the time of application by the small businessman to the bank. And in the time of that final formal application from the bank to SBA there could have been a big discrepancy?

Mr. **Holloway**. That is right.

Mr. **LaFalce**. Will you be able to give me the data that I am seeking?

Mr. **Holloway**. The data that you are seeking can be matched up in a special array, arraying it directly against prime and based on a computer run it would reflect it. We will, if necessary, get another computer run to reflect it on that basis.

Mr. **LaFalce**. That's really what is most relevant. If you haven't given me that, you haven't given the answer I've been looking for.

I want to call upon the ranking minority member, Mr. Stanton. I would like to stay just a few more minutes in case Mr. Stanton has any questions, Mr. Cardenas.

Mr. **Stanton**. Thanks, John. I did want to recognize Mr. Weber in a minute and simply to clarify a couple of questions I have in my mind.

First of all, the agency's policy is to negotiate the best possible loan, right, guaranteed loans, regardless of prime, and is it a fair assumption you have better luck in some part of the country than you do in others in this regard?

Mr. **Holloway**. Yes, sir. In the more rural, less urbanized areas of the country, in general, the local cost of money rates to the banks will be less and the loans are made at somewhat lower rates.

Mr. **Stanton**. And it is more in the sophisticated areas whereby you find a more direct correlation between the prime and the actual price that you would get.

Mr. **Holloway**. In the money center cities the rates are more sensitive, the interest rates are much more sensitive.

Mr. **Stanton**. The committee, of course, is very well aware that you cannot and do not have any influence over the exact prime in itself. We are definitely concerned, of course, and our prime responsibility is to insure that the small business people we represent get the best possible price on their money that we can possibly get for them, and consistent with our rules and regulations—and that is why we want rules and regulations—to make sure the money they get is as reasonable as can be and, second, to insure that, wherever possible, money is available, which is the bottom line.

That figure that you quoted me over the last 6 months, though, it is a fact that, prime or no prime—and I just quickly came to this conclusion—that better than 50 percent of your loan guarantees over the first 6 months of fiscal year 1981 averaged 16, 16½ percent or less; is that correct?

Mr. **Holloway**. That is correct.

Mr. **Stanton**. It is interesting in light of the prime moving rapidly and moved down slowly, and then moved up rapidly. Of course, everything is in retrospect. Last February a house loan at 14 percent was exorbitant, and now, in light of 17 percent, that 14 percent looks pretty good.

Mr. Holloway. Many banks with a stake in the community, a customer relationship with the small business, have given rates substantially under the prime, and recognize, in fact, that there is a limit to what the small business can pay. So, by negotiation between the bank and the borrower, a lot of that concern is accommodating. Not all of them charge the very, very maximum rate.

Mr. Stanton. Thank you, Mr. Chairman.

Mr. Cardenas. Mr. Chairman, I apologize. I must excuse myself to make that Senate hearing by 11:30. Mr. Ed Holloway will stay here to answer any further questions, if I may be excused.

Mr. LaFalce. Did you have any questions, Mr. Weber?

Mr. Ed Weber. My questions can go to Mr. Holloway. Thank you.

Mr. LaFalce. All right, Mr. Cardenas. I hope you heard, though, that I want to have hearings again shortly, perhaps by the end of October or the beginning of November.

Also, I would hope that you would only not ask for comments but will make some independent study on your own as to what might be an appropriate way of helping the small businessman get a lower interest rate with the device of that guarantee. I think the Office of Advocacy within SBA has been studying this issue, and perhaps the two of you can work together.

Mr. Cardenas. I would also like to thank you for inviting me. I appreciated the comments of the previous witnesses and certainly their words are well taken.

Mr. LaFalce. Thank you.

Mr. Weber?

Mr. Ed Weber. The interest on the loan is also affected by the service charges and origination fees and lending charges, all those things are loaded into the loan package. I wonder what is the policy or what are the rules now on those service charges?

Mr. Holloway. The policy on charges by any participant is a policy that only charges for actual services rendered are permitted. Beyond that, there is a 1-percent fee that we charge the bank for the guarantee. That 1-percent fee is permitted to be passed through to the small business borrower. So his fee is 1 percent, plus reimbursement for actual charges or services rendered.

Mr. Ed Weber. But didn't the banks used to charge an origination fee?

Mr. Holloway. They charge an origination fee on some loans. They do not charge them on SBA loans, since they are not permitted on SBA loans.

Mr. Ed Weber. Origination fees have never been permitted on SBA loans?

Mr. Holloway. They have never been permitted, an origination fee, per se, to my knowledge, Congressman. It has always been the rule that they are permitted to charge for actual services rendered. If an appraisal is necessary and it costs $100, then they pass on the $100.

Mr. Ed Weber. The only other question I had relates to whether you could measure any effect, when you dropped the percentage of guarantee.

Earlier in the year, some regional district offices reacted to the tightening of the guarantee amounts by dropping the percentage of guarantee down to something like 75 percent. Have you been able to measure the effect on loan activities as a result of dropping that percentage down?

Mr. **Holloway.** Yes, sir. It cut it back dramatically, which is what it had to do at the time, in that the lack of sufficient guarantee authority to meet the full demand was our problem. We suddenly found ourselves with the 25-percent cutback at a national budget of $3 billion instead of $4 billion that we had started out the year. Accordingly, volume did drop. However, through the conferencing process, the $4 billion was ultimately restored and we turned the field offices loose again to accommodate that many loans if the demand was there.

I might say that in this next fiscal year apparently our number, instead of $4 billion, will be $2.8 billion, so we will again at least look at the most equitable ways of allocating or apportioning such guarantee authority as we do have.

Mr. **Ed Weber.** I would think that brief bit of history would be worth highlighting in view of what we were discussing earlier today about the possibility of reducing the guarantee amount down from 90 percent to——

Mr. **Holloway.** I might add, Congressman, that apparently, although it has not been finally signed into law, there has been a conference in the past couple of days in the budget reconciliation process that, in effect, means the new rule at SBA is that we must guarantee not less than 90 percent on loans up to $100,000. There will be a 70- to 90-percent range of guarantees on loans from over $100,000 up to about a total of $715,000.

In other words, we will have discretion in the 70- to 90-percent range, until you get to financing of about $715,000. At that point we can only guarantee 70 percent so that we do not exceed our $500,000 statutory limitation.

For example, we could arguably guarantee a $1 million loan at 50 percent.

Mr. **Ed Weber.** Did the reconciliation bill make any changes in those service charges you were talking about?

Mr. **Holloway.** No, sir, not in those charges we were discussing. The new law did provide an additional 10-percent charge for extensions or refinancings which would extend beyond 10 years.

Mr. **Ed Weber.** Thank you.

Mr. **LaFalce.** I would point out the provisions of the reconciliation bill were put in at the behest of the Small Business Administration.

Mr. Roemer?

Mr. **Roemer.** Thank you, Mr. Chairman.

I would like to ask you about the comments made by an earlier witness, Mr. Piercy of Kansas City, when he made the point—and I am reading—"Another problem with SBA loans is that they are often adjusted on a twice-a-year basis instead of more often, such as monthly."

What are the regulations regarding that? Is there any hard and fast rule, or is that open to negotiation?

Mr. **Holloway.** The regulation presently is that it may not be adjusted any more often than quarterly. However, the recent proposal that is now in the Federal Register will permit fluctuations as often as daily, if adopted. Many banks, on their non-SBA business, already adjust variable rate loans on a daily basis, so it is to bring that into conformity, if that is adopted, making the rate more sensitive both on the upside and on the downside.

Mr. **Roemer**. It can work both ways, can't it?

Mr. **Holloway**. It can work both ways.

Mr. **Roemer**. But it might be a question of equity to allow more frequent adjustments in the rates.

Mr. **Holloway**. The thinking behind the proposal was that it is more equitable to allow a more frequent adjustment, particularly in view of the fact that interest rates are probably at a very high level and can be anticipated to come down; thus we would not lock people in at the 22-percent rate but permit that to come down as quickly as rates fell. If it fell over a 2-month period, it would be down in 2 months.

Mr. **Roemer**. One final question, following what Mr. Weber had to say, on the fee, from the standpoint of the banker on these loans.

There is no fee? I'm not clear on that.

Mr. **Holloway**. There is no point, if you will, or two points or three points charged as an origination fee. There is only permitted charges for actual services rendered and there is permitted to pass on a 1 percent one-time fee that the bank must pay. On a $100,000 loan, guaranteed 90 percent, that is a $90,000 guaranteed portion, the bank must pay us $900 for that guarantee. They are permitted to pass that $900 on to the small business.

Mr. **Roemer**. Hasn't that been changed, or proposed to be changed——

Mr. **Holloway**. It was proposed, and I believe the way the final bill has come out, we will still have our present rule on that. It is not being changed is my understanding.

Mr. **Roemer**. Which will allow 1 percent of the amount that you guarantee to be charged the bank, paid to you, and they, in turn, pass it on to the customer?

Mr. **Holloway**. It continues the present rule is my understanding.

Mr. **Roemer**. OK. Thank you very much.

Mr. **Holloway**. But I would like to point out, Mr. Chairman, if I may, that on the not guaranteeing less than 90 percent, the administration did take a formal written position in opposition to that. We felt we should have a little more discretion in a credit area, and in a sense that is legislating a credit consideration. However, I believe we can live very nicely with the way it came out in that the smaller loans up to $100,000 would get the largest guarantees and that when you get over that figure you are more in the area of negotiation—that is, the area of 70 to 90 percent.

Mr. **LaFalce**. Didn't you have total discretion in the past?

Mr. **Holloway**. No; we had not less than 90 percent as a mandate.

Mr. **LaFalce**. You couldn't give us the 90 at all?

Mr. **Holloway**. I'm sorry. No greater than 90.

Mr. **LaFalce**. No greater. So you did have discretion?

Mr. **Holloway**. We did have discretion. A lot of loans were made at lesser guaranteed percentages, although in recent years there has been a tendency, since the development of the secondary market, to guarantee increasingly loans at higher percentages.

Mr. LAFALCE. As I recall, you initially came forward with a proposal, that would have established a lower maximum. Ninety percent is now the maximum.

Mr. HOLLOWAY. No, sir. Now it is not less than 90 percent—oh, I'm sorry. The present law has not yet been signed into the reconciliation law.

Mr. LAFALCE. It is now no more than 90 percent, correct?

Mr. HOLLOWAY. It is now no more than 90 percent, that is correct.

Mr. LAFALCE. But I understand you initially came forward with a proposal that would have permitted you much greater flexibility and statutory guidance to lower that.

Mr. HOLLOWAY. Our proposal was to continue the existing rule, whereby we were permitted to negotiate on a case-by-case basis and get a larger bank participation where the bank was willing to participate, and the credit factors were such that the credit could be accommodated on that basis.

Now we will be at not less than 90 percent on loans up to $100,000, with no discretion. We will either not make it, or we will make it at 90 percent, if that is finally signed into law.

Mr. LAFALCE. That doesn't mean you could guarantee it 100 percent.

Mr. HOLLOWAY. Yes, sir, it does.

Mr. LAFALCE. Then that is terrible draftsmanship.

Mr. HOLLOWAY. I would agree.

Mr. LAFALCE. I think the whole intent was to insure that the SBA didn't do for the $100,000 loan what they reportedly wished to do, that is give loan guarantees at less than 90 percent. The individuals who drafted that provision didn't want you to give 100 percent. They simply didn't want you to go down to 70 percent.

Mr. HOLLOWAY. I don't think you will see any 100-percent guarantees, Mr. Chairman, unless we get a different signal than we have had so far.

Mr. LAFALCE. But you are saying you would be legally able to?

Mr. HOLLOWAY. Legally we would be able to, as I understand the bill. It says not less than 90 percent.

Mr. ROEMER. Would the chairman yield on that point?

Mr. LAFALCE. Yes.

Mr. ROEMER. Is your flexibility—and as the chairman said——

Mr. LAFALCE. It is OMB drafted.

Mr. ROEMER. Right. I'm worried about the draft myself.

You have a $500,000 limit; is that right?

Mr. HOLLOWAY. Yes, sir, a statutory maximum for the SBA guaranteed portion.

Mr. ROEMER. It is conceivable—not probable, but conceivable—that you could make a 10-percent guarantee of a $5 million loan then?

Mr. HOLLOWAY. That is correct, sir.

Mr. ROEMER. And the law allows you that flexibility?

Mr. HOLLOWAY. Yes, sir, it does.

Mr. ROEMER. Thank you.

Mr. **LaFalce**. We have time constraints so we are going to bring today's hearing to a close. I thank you very much and look forward to reviewing the comments and the evaluation of those comments that we have made to SBA regarding this very important issue. Thank you.

Mr. **Holloway**. Thank you, Mr. Chairman.

[Whereupon, at 11:40 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

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